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In this Update:

- 12.13 “Sentencing Procedure” updated by Dr Anthony Hopkins, Senior Lecturer, ANU College of Law current to 1 June 2017
- 17.15 “Valuation of Property and Tax and Revenue Issues” Chs 1, 6, 10 updated by Wayne Lonergan and Julie Planinic, Directors, Lonergan Edwards & Associates Ltd current to 1 May 2017 (Ch 10), 15 June 2017 (Ch 6)
- 31.4 “Deductions” Chs 6–9 updated by Adam Ahmed, Chartered Accountant, Director, Adam Ahmed & Co current to 1 July 2017
- 35.10 “Penalties and Forfeiture” Christoph Liedermann, Barrister, Chalfont Chambers current to 1 June 2017

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Criminal Sentencing

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Introduction

Definition

[12.13.10] A "sentence" is most appropriately defined as "an order which definitively disposes of the consequences of conviction".[1] A sentence is given after a person has pleaded guilty, or after an offence has been found proved when the person has pleaded not guilty.

A sentencer must first determine the factual basis on which a sentence should be imposed.[2] A plea of guilty is only an admission of the facts necessary to prove each element of an offence charged.[3] Commonly, where there is a plea of guilty, a relatively detailed statement of facts will be agreed by the prosecution and the defence.[4] However, there may be substantial dispute between the prosecution and the defence concerning the factual circumstances of the offence, necessitating a fact-finding process.[5]

Sentencing hearings are adversarial in nature[6] and sentencers must balance the needs of:

(1) offenders (ascertained through defence submissions, independently prepared reports such as pre-sentence reports and any evidence adduced by the defence);

(2) the community (addressed in prosecution submissions and prosecution appeals on sentence); and

(3) victims (ascertained through victim impact statements).[7]

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1 *R v Warfield* (1994) 34 NSWLR 200; 73 A Crim R 516 (CCA), 205 (Hunt CJ) (NSWLR) (referring to *Griffiths v The Queen* (1977) 137 CLR 293; 51 ALJR 749).
2 *R v Duong* [1998] 4 VR 68; (1997) 99 A Crim R 218 (CA).
3 *R v O'Neill* [1979] 2 NSWLR 582; (1979) 1 A Crim R 59 (CCA).
4 *R v Storey* [1998] 1 VR 359; (1996) 89 A Crim R 519 (CA), 366 (VR).
5 *R v Riley* [1896] 1 QB 309, 318 (Hawkins J); *R v Maitland* [1963] SASR 332 (FC), 334 (the Court).
6 *Pantorno v The Queen* (1989) 166 CLR 466; 63 ALJR 317; 38 A Crim R 258.
7 See, eg, *R v Mielicki* (1994) 73 A Crim R 72 (VCCA), 79 (the Court).

Scope of Subtitle

[12.13.20] This Subtitle focuses on what happens during the course of a sentencing hearing. The respective roles of the parties involved in the hearing are discussed (see [12.13.140]–[12.13.170]), as are the onus and standard of proof to determine the factual basis of the sentence (see [12.13.280]–[12.13.320]), and the use of pre-sentence reports (see [12.13.430]–[12.13.450]) and victim impact statements (see [12.13.460]–[12.13.550]) throughout the various jurisdictions in Australia.

This Subtitle then deals with whether reasons should be given by sentencers for the sentence imposed (see [12.13.660]–[12.13.670]) and the role of the appeal courts (see [12.13.780]–[12.13.800]) and the High Court (see [12.13.810]–[12.13.820]) in relation to appeals against sentences.

Related Titles and Subtitles

[12.13.30] Sentencing hearings are central to the operation of the criminal justice system. Therefore, this Subtitle should be read in conjunction with 11 *Criminal Procedure*.

Within 12 *Criminal Sentencing*, relevant Subtitles are “Purposes of Sentencing” [12.1.10]ff, “Relevant Factors” [12.2.10]ff, “Interpretation of Penalty Provisions” [12.3.10]ff, “Sentencing for Specific Offences” [12.4.10]ff and “Sentencing of Children” [12.12.10]ff.

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Roles of Parties in Sentencing Process

Role of Sentencer

[12.13.140] The role of a sentencing judge or magistrate is to impose a sentence on an offender. A sentence imposed must reflect the circumstances of the offence[1] and of the offender.[2] Legislative provision has been made for this.[3] Sentencers must find the facts to establish these circumstances to the appropriate standard: see [12.13.280]–[12.13.320].

Although sentencers may consider aggravating factors, they cannot take into account circumstances established in evidence that would render an offender liable to a more serious penalty than the one prescribed for the offence for which the offender has pleaded or been found guilty.[4] Thus, for example, if a person is to be sentenced for an assault occasioning actual bodily harm, evidence tending to show that the person was guilty of maliciously inflicting grievous bodily harm (and thus liable to a more serious penalty) cannot be taken into account. This reflects the "fundamental and important principle, that no one should be punished for an offence of which he [or she] has not been convicted".[5]

Sentencers can take account of proof of other offences in order to defeat claims to mitigation of penalty.[6] Sentences must be in accordance with the relevant sentencing principles, encompassing both general sentencing principles and sentencing principles relevant to the specific offence.[7] When imposing the sentence, sentencers exercise a judicial discretion,[8] having regard to the purposes of sentencing.[9]

---

1 *R v Teremoana* (1990) 54 SASR 30; 49 A Crim R 207 (CCA), 36–39 (Cox J) (SASR); *R v De Simoni* (1981) 147 CLR 383; 55 ALJR 469; 5 A Crim R 329, 389 (Gibbs CJ), 396 (Wilson J) (CLR); *R v Boyd* [1975] VR 168 (FC), 172 (Gowans J); *R v D* [1996] 1 Qd R 363; (1995) 80 A Crim R 50 (CA).

2 *Barbaro v The Queen* (2014) 253 CLR 58; 88 ALJR 372; 236 A Crim R 116; [2014] HCA 2, [34] (French CJ, Hayne, Kiefel and Bell JJ); *Wong v The Queen* (2001) 207 CLR 584; 76 ALJR 79; [2001] HCA 64, [75] (Gaudron, Gummow and Hayne JJ), citing *R v Williscroft* [1975] VR 292 (SC), 300 (Adam and Crockett JJ).

3 *Crimes Act 1914* (Cth) s 16A(2); *Crimes (Sentencing) Act 2005* (ACT) s 33; *Crimes (Sentencing Procedure) Act 1999* (NSW) s 21A; *Sentencing Act 1995* (NT) s 5(2); *Penalties and Sentences Act 1992* (Qld) s 9(2); *Criminal Law (Sentencing) Act 1988* (SA) s 10(1); *Sentencing Act 1991* (Vic) s 5(2); *Sentencing Act 1995* (WA) ss 6(2), 7, 8. In Tasmania, courts are required to consider the circumstances of the offence when determining whether to record a conviction or when determining the eligibility of an offender to parole pursuant to *Sentencing Act 1997* (Tas) ss 9, 17 respectively.

4 A sentencing judge cannot take into account "as matters of aggravation facts established in the evidence which would have rendered the offender liable to a more serious penalty than that which is

prescribed for the offence to which he has pleaded guilty or of which he has been found guilty": *R v Overall* (1993) 71 A Crim R 170 (NSWCCA), 177 (Hunt CJ). See also *R v De Simoni* (1981) 147 CLR 383; 55 ALJR 469; 5 A Crim R 329, 389–390 (Gibbs CJ), 396 (Wilson J) (CLR); *R v Boyd* [1975] VR 168 (FC), 172 (Gowans J); *R v King* (1925) 25 SR (NSW) 218; 24 WN (NSW) 50; *R v Bright* [1916] 2 KB 441 (CCA).

5 *R v De Simoni* (1981) 147 CLR 383; 55 ALJR 469; 5 A Crim R 329, 389 (Gibbs CJ) (CLR).

6 *R v Huchison* [1972] 1 WLR 398 (CA), 399–400 (Phillimore LJ); *R v H* (1980) 3 A Crim R 53 (NSWCCA), 59 (Street CJ); *R v Cooksley* [1982] Qd R 405; (1982) 6 A Crim R 128 (CCA), 135–136 (McPherson J) (Qd R) (note that McPherson J concludes that the offender must explicitly admit the offences in question); *R v Benasic* (1987) 77 ALR 340 (FCA), 342 (Fox J); *Weininger v The Queen* (2003) 212 CLR 629; 77 ALJR 872; 140 A Crim R 184; [2003] HCA 14, [32] (Gleeson CJ, McHugh, Gummow and Hayne JJ); *Director of Public Prosecutions (Vic) v Di Nunzio* (2004) 78 ALD 97; [2004] VSCA 78, [27].

7 See generally "Relevant Factors" [12.2.10]ff; "Sentencing for Specific Offences" [12.4.10]ff.

8 *Barbaro v The Queen* (2014) 253 CLR 58; 88 ALJR 372; 236 A Crim R 116; [2014] HCA 2, [25] (French CJ, Hayne, Kiefel and Bell JJ); *Wong v The Queen* (2001) 207 CLR 584; 76 ALJR 79; [2001] HCA 64, [7] (Gleeson CJ); *Lowndes v The Queen* (1999) 195 CLR 665; 73 ALJR 1007; [1999] HCA 29, [13]–[15]; *R v Geddes* (1936) 36 SR (NSW) 554; 53 WN (NSW) 157 (CCA), 554–555 (Jordan CJ) (SR (NSW))).

9 *Veen v The Queen (No 2)* (1988) 164 CLR 465; 62 ALJR 224; 33 A Crim R 230 (HCA), 476 (Mason CJ, Brennan, Dawson and Toohey JJ) (CLR); *Crimes Act 1914* (Cth) s 16A(2); *Crimes (Sentencing) Act 2005* (ACT) s 7; *Crimes (Sentencing Procedure) Act 1999* (NSW) s 3A; *Sentencing Act 1995* (NT) s 5(1); *Penalties and Sentences Act 1992* (Qld) s 9(1); *Criminal Law (Sentencing) Act 1988* (SA) s 10; *Sentencing Act 1997* (Tas) s 3.

Role of Prosecution Counsel

[12.13.150] The traditional role of a prosecutor is as a "minister of justice", whose primary duty is to assist the court and see that justice is done.[1] To ensure that justice is done, a prosecutor must, fairly and honestly, present material to the court, and not try and secure the highest penalty possible.[2] Prosecutors should be active in assisting courts in ascertaining relevant sentencing principles.[3] It is recognised that the role of a prosecutor (when assisting a court) is to ensure that the court does not fall into appellable error.[4] Prosecutors should ensure that the court is informed about comparable sentences but are not permitted to make submissions with respect to the range of available sentences.[5] Prosecutors should not contend for a particular sentence.[6] If a sentencing court gives a preliminary indication of a proposed sentence that the prosecutor regards as disclosing error, the duty of the prosecutor is to draw attention to the relevant facts, sentencing principle or comparable sentences, rather than contend that a particular result is in error as being outside the range.[7]

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1 *R v Lucas* [1973] VR 693 (FC), 705 (Newton and Norris JJ); *King v The Queen* (1986) 161 CLR 423; 60 ALJR 685; 21 A Crim R 436. See generally J Willis, "Some Aspects of the Prosecutor's Role at Sentencing" (1996) 6 JJA 38.

2 *King v The Queen* (1986) 161 CLR 423; 60 ALJR 685; 21 A Crim R 436, 426 (Murphy J) (CLR); *R v Tait* (1979) 46 FLR 386 (FCAFC), 389.

3 *R v Acerbi* (1983) 11 A Crim R 90 (WASCA), 92 (Rowland J).

4 *R v Tait* (1979) 46 FLR 386 (FCAFC), 389.
5 *Barbaro v The Queen* (2014) 253 CLR 58; 88 ALJR 372; 236 A Crim R 116; [2014] HCA 2, 71–74 (French CJ, Hayne, Kiefel and Bell JJ) (CLR).
6 *Barbaro v The Queen* (2014) 253 CLR 58; 88 ALJR 372; 236 A Crim R 116; [2014] HCA 2, [39] (French CJ, Hayne, Kiefel and Bell JJ); *Higgins v Fricker* (1992) 63 A Crim R 473 (SASCFC), 478 (Mullighan J).
7 *Barbaro v The Queen* (2014) 253 CLR 58; 88 ALJR 372; 236 A Crim R 116; [2014] HCA 2, [39] (French CJ, Hayne, Kiefel and Bell JJ); cf Gageler J at [62].

[12.13.160] A prosecutor's role is to provide a sentencer with all the facts and circumstances in which the offence was committed, as they are known to the prosecution.[1] The presentation of facts and subsequent submissions as to penalty must be made fairly and "even-handedly".[2] Prosecutors have a duty to provide the sentencing court with the antecedents of the offenders[3] and any sentences which were imposed on co-offenders.[4]

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1 *R v Gamble* [1983] 3 NSWLR 356; (1983) 72 FLR 352; 14 A Crim R 179 (CCA), 360 (Lee J) (NSWLR).
2 *R v Wilton* (1981) 28 SASR 362; 4 A Crim R 5 (CCA), 368 (King J) (SASR).
3 *R v Gamble* [1983] 3 NSWLR 356; (1983) 72 FLR 352; 14 A Crim R 179 (CCA), 359 (Street CJ) (NSWLR); *R v Rumpf* [1988] VR 466; (1987) 29 A Crim R 252 (CCA). "Antecedents" refers to an accused's criminal record and background.
4 *Pecora v The Queen* [1980] VR 499; (1979) 1 A Crim R 293 (CCA); *R v Rainford* [2003] VSCA 49.

Role of Defence Counsel

[12.13.170] The role of a defence counsel is to act on behalf of their client to achieve the "least punitive measure properly available".[1] This involves ensuring that all the necessary submissions and evidence in mitigation are put before a sentencer.[2] Defence counsel should identify all relevant sentencing factors, including those which favour the offender, and identify and canvass all sentencing alternatives reasonably open.[3] However, there is an overriding duty on defence counsel, as with all legal practitioners, to assist the courts and not to deceive or mislead them.[4] This does not mean that defence counsel is required to disclose to the court detrimental facts, such as prior convictions.[5]

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1 *R v Anzac* (1987) 31 A Crim R 310; 88 FLR 465 (CCA), 320 (A Crim R).
2 *Putti v Simpson* (1975) 6 ALR 47 (NTSC), 51 (Muirhead J).
3 *R v Anzac* (1987) 31 A Crim R 310; 88 FLR 465 (CCA), 320 (A Crim R).
4 *Giannarelli v Wraith* (1988) 165 CLR 543; 62 ALJR 611; 35 A Crim R 1, 556 (Mason CJ) (CLR); *R v Rumpf* [1988] VR 466; (1987) 29 A Crim R 252 (CCA). See the Law Society and Bar Association Rules of all jurisdictions.
5 *R v Rumpf* [1988] VR 466; (1987) 29 A Crim R 252 (CCA), 472 (McGarvie J) (VR).

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Factual Basis of Sentence

General

[12.13.280] Difficulties in establishing the factual basis upon which an offender should be sentenced arise when a jury's verdict can be seen to be ambiguous,[1] or where there are disputed facts, either in aggravation or mitigation, on a plea of guilty.[2] The issues to be addressed are:

(1) what constitutes facts in aggravation or mitigation;

(2) who bears the burden of proof; and

(3) what standard of proof applies.

It is up to a sentencer (see [12.13.140]) to find the facts relevant to the sentence, consistent with the jury's verdict (if there is one), and to determine disputed facts on a plea of guilty.[3]

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1 For example, a verdict of guilty to manslaughter where the accused was indicted on murder can mean that the death was from an unlawful and dangerous act (without the mens rea for murder), or that the accused had a partial defence of provocation. This issue was raised on the facts of *R v Isaacs* (1997) 41 NSWLR 374; 90 A Crim R 587 (CCA).

2 See Australian Law Reform Commission, *Sentencing: Procedure*, Discussion Paper No 29 (ALRC, 1987) Ch 3.

3 *R v Morrison* [1999] 1 Qd R 397; (1998) 103 A Crim R 460 (CA), 422 (Williams J) (Qd R); *R v Storey* [1998] 1 VR 359; (1996) 89 A Crim R 519 (CA).

Disputed Facts in Aggravation

[12.13.290] A "disputed fact in aggravation" is a contested fact which is unfavourable to an offender.[1] It covers not only facts that aggravate the offence, but also

> any circumstance which the judge proposes to take into account adversely to the interests of the accused – "adversely" in the sense that it is "likely to result in a more severe sentence than would otherwise be the case".[2]

Whether a particular fact is aggravating (or indeed mitigating) depends on what the sentencer proposes to make of the fact in relation to the offender.[3]

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1 *R v Storey* [1998] 1 VR 359; (1996) 89 A Crim R 519 (CA).

2 *R v Storey* [1998] 1 VR 359; (1996) 89 A Crim R 519 (CA), 469 (Winneke P, Brooking and

Hayne JJA and Southwell AJA) (VR), citing *Langridge v The Queen* (1996) 17 WAR 346; 87 A Crim R 1 (CCA), 21 (Kennedy J) (A Crim R).

3 *Anderson v The Queen* (1993) 177 CLR 520; 67 ALJR 911; 67 A Crim R 582; *Weininger v The Queen* (2003) 212 CLR 629; 77 ALJR 872; 140 A Crim R 184; [2003] HCA 14, [27] (Gleeson CJ, McHugh, Gummow and Hayne JJ) (cannot apply a "single label" to the appellant's character and antecedents).

[12.13.300] It is now well established in all jurisdictions, in general terms, that the prosecution must prove disputed facts in aggravation (see [12.13.290]) beyond reasonable doubt.[1] The rationale behind this rule is that offenders should not be deprived of their liberty unless there is proof beyond reasonable doubt.[2]

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1 *Filippou v The Queen* (2015) 256 CLR 47; 89 ALJR 776; [2015] HCA 29, [64] (French CJ, Bell, Keane and Nettle JJ with Gageler J agreeing at [74]); *Weininger v The Queen* (2003) 212 CLR 629; 77 ALJR 872; 140 A Crim R 184; [2003] HCA 14, [18] (Gleeson CJ, McHugh, Gummow and Hayne JJ); *R v Olbrich* (1999) 199 CLR 270; 73 ALJR 1550; 108 A Crim R 464; [1999] HCA 54, [27] (Gleeson CJ, Gaudron, Hayne and Callinan JJ); *R v Capobianco* (1978) 20 ACTR 29; *R v Isaacs* (1997) 41 NSWLR 374; 90 A Crim R 587 (CCA); *Browne v Smith* (1974) 24 FLR 1 (NTSC); *R v Morrison* [1999] 1 Qd R 397; (1998) 103 A Crim R 460 (CA); *Anderson v The Queen* (1993) 177 CLR 520; 67 ALJR 911; 67 A Crim R 582; *R v Turnbull* (1994) 4 Tas R 216; *R v Storey* [1998] 1 VR 359; (1996) 89 A Crim R 519 (CA); *Langridge v The Queen* (1996) 17 WAR 346; 87 A Crim R 1 (CCA). Note that the sentences for Commonwealth offences apply the State or Territory procedures (where the case is heard): *Judiciary Act 1903* (Cth) s 68. See also *Evidence* "Standard of Proof" [16.3.220].

2 *Langridge v The Queen* (1996) 17 WAR 346; 87 A Crim R 1 (CA); *R v Morrison* [1999] 1 Qd R 397; (1998) 103 A Crim R 460.

Disputed Facts in Mitigation

[12.13.310] The definition of a "disputed fact in mitigation" is a fact that "if proved, would favour the accused in the sense that it would be likely to result in a less heavy sentence".[1] Whether a particular fact is mitigating (or aggravating) depends on what the sentencer proposes to make of the fact in relation to the offender.[2]

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1 *R v Morrison* [1999] 1 Qd R 397; (1998) 103 A Crim R 460 (CA), 422 (Williams J) (Qd R).

2 *Anderson v The Queen* (1993) 177 CLR 520; 67 ALJR 911; 67 A Crim R 582; *Weininger v The Queen* (2003) 212 CLR 629; 77 ALJR 872; 140 A Crim R 184; [2003] HCA 14, [27] (Gleeson CJ, McHugh, Gummow and Hayne JJ).

[12.13.320] The defence must prove facts in mitigation, which are disputed by the prosecution, on the balance of probabilities.[1] This leaves the question of how a sentencer is to proceed where the prosecution cannot prove a fact or circumstance which would be adverse to the offender beyond reasonable doubt, and yet the defence cannot prove a more favourable mitigating version on the balance of probabilities. In this instance, "the judge may proceed to sentence the offender on the basis that neither of the competing possibilities is known".[2]

1 *Weininger v The Queen* (2003) 212 CLR 629; 77 ALJR 872; 140 A Crim R 184; [2003] HCA 14, [18] (Gleeson CJ, McHugh, Gummow and Hayne JJ); *R v Olbrich* (1999)199 CLR 270; 73 ALJR 1550; 108 A Crim R 464; [1999] HCA 54, [27] (Gleeson CJ, Gaudron, Hayne and Callinan JJ); *R v Isaacs* (1997) 41 NSWLR 374; 90 A Crim R 587 (CCA); *R v Morrison* [1999] 1 Qd R 397; (1998) 103 A Crim R 460 (CA), 422 (Williams J) (Qd R); *R v Zhong Wen Huang Wong* (1995) 16 WAR 219 (WASCFC); *R v Storey* [1998] 1 VR 359; (1996) 89 A Crim R 519 (CA), 360–370 (VR). See also *Evidence* “Standard of Proof” [16.3.260].

2 *Filippou v The Queen* (2015) 256 CLR 47; 89 ALJR 776; [2015] HCA 29, [64] (French CJ, Bell, Keane and Nettle JJ), citing *R v Olbrich* (1999) 199 CLR 270; 73 ALJR 1550; 108 A Crim R 464; [1999] HCA 54, [24] (Gleeson CJ, Gaudron, Hayne and Callinan JJ).

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Material Relevant for Determining Appropriate Sentence

Pre-sentence Reports

Power to Order Pre-sentence Report

[12.13.430] In all the States and Territories there is power to order a pre-sentence report.[1] A pre-sentence report may be prepared by a qualified person employed by the State or Territory government. Pre-sentence reports assist courts in determining what sentencing options are realistically available for particular defendants. In certain jurisdictions it is mandatory to order a pre-sentence report or assessment report if the sentencer is considering imposing a particular sentence, such as a community service order, intensive correction order or home detention order.[2]

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1 *Crimes (Sentencing) Act 2005* (ACT) Pt 4.2; *Crimes (Sentencing Procedure) Act 1999* (NSW) ss 69 (intensive correction order), 80 (home detention), 88 (community service order), 95B (good behaviour bond with specific conditions), 100O (intervention program order); *Sentencing Act 1995* (NT) s 105; *Corrective Services Act 2006* (Qld) s 344; *Criminal Law (Sentencing) Act 1988* (SA) s 8; *Sentencing Act 1997* (Tas) s 82; *Sentencing Act 1991* (Vic) s 8A; *Sentencing Act 1995* (WA) ss 20(1)–(2). State and Territory courts have jurisdiction with respect to Commonwealth offences: *Judiciary Act 1903* (Cth) s 68(2). *Judiciary Act 1903* (Cth) ss 68(1), 79 and *Constitution* s 80 provide that State and Territory procedural laws apply to persons charged under Commonwealth law, including, by implication, procedures relating to sentencing such as pre-sentence reports. Although the Federal Court of Australia has had the procedural framework to deal with criminal offences since 2009, there are no provisions dealing with pre-sentence reports: see *Federal Court of Australia Amendment (Criminal Jurisdiction) Act 2009* (Cth).

2 See, eg, *Crimes (Sentencing) Act 2005* (ACT) ss 78 (intensive correction orders), 89(1) (community service); *Crimes (Sentencing Procedure) Act 1999* (NSW) ss 67(2) (intensive corrections order), 81, 86(2) (community service order); *Sentencing Act 1995* (NT) ss 35, 39B (community based order), 45(1)(a) (home detention order), 48B(1) (community custody order), 103(1); *Sentencing Act 1997* (Tas) s 27D (drug treatment order); *Sentencing Act 1991* (Vic) s 37 (community correction order); *Sentencing Act 1995* (WA) s 68 (intensive supervision order). In Queensland, a community service order can only be imposed on an adult if the court is satisfied that the offender is a suitable person to perform the work: *Penalties and Sentences Act 1992* (Qld) s 101. There is no mandatory provision in South Australia. However, the court may be notified that no suitable work is available: *Criminal Law (Sentencing) Act 1988* (SA) s 45. Note that community service is available in Victoria and Western Australia but it forms part of a community-based order. See "Community Based Orders" [12.5.1330]–[12.5.1520].

Content of Pre-sentence Report

[12.13.440] Legislation indicates what matters may be addressed in a pre-sentence report. In the Australian Capital Territory, the Northern Territory, Tasmania and Victoria, the pre-sentence report can set out matters such as the offender's age, social history and background, medical and psychiatric history, educational background, employment history, circumstances of other offences of which the offender has been found guilty, financial circumstances, special needs, and any assistance which could be available to the offender and from which the offender may benefit.[1]

The New South Wales legislation provides that the pre-sentence report should address matters such as the offender's suitability for community service work and whether it is appropriate in all the circumstances for the offender to perform the work.[2] The Queensland legislation provides that a pre-sentence report may include an offender's criminal history.[3] In South Australia, the pre-sentence report can address the offender's physical or mental condition, or the offender's personal circumstances or history.[4] In Western Australia, the content of the pre-sentence report includes matters about an offender that are relevant to their sentencing. Such matters may include assessments of the offender's physical or mental condition, whether or not a court has asked for them.[5]

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1 *Crimes (Sentencing) Act 2005* (ACT) s 40A; *Sentencing Act 1995* (NT) s 106; *Sentencing Act 1997* (Tas) s 83; *Sentencing Act 1991* (Vic) s 8B.
2 *Crimes (Sentencing Procedure) Act 1999* (NSW) ss 86(1), 89(1).
3 *Corrective Services Act 2006* (Qld) s 344(2).
4 *Criminal Law (Sentencing) Act 1988* (SA) s 8(1).
5 *Sentencing Act 1995* (WA) ss 21(2)–(3).

Disputing Contents of Pre-sentence Report

[12.13.450] In the Australian Capital Territory, South Australia, Tasmania and Victoria,[1] the prosecution (see [12.13.150]–[12.13.160]) or the defence (see [12.13.170]) may cross-examine the author of a pre-sentence report. In the Australian Capital Territory and South Australia, that right is automatic.[2] In Victoria, the author can only be cross-examined if notice has been given.[3]

In New South Wales, the Northern Territory, Queensland and Western Australia, there is no express statutory provision to cross-examine the author of a pre-sentence report. However, in these jurisdictions there is authority that states that it can be done.[4]

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1 *Crimes (Sentencing) Act 2005* (ACT) s 46; *Criminal Law (Sentencing) Act 1988* (SA) s 8(5); *Sentencing Act 1997* (Tas) s 88; *Sentencing Act 1991* (Vic) s 8D.
2 *Crimes (Sentencing) Act 2005* (ACT) s 46; *Criminal Law (Sentencing) Act 1988* (SA) s 8(5).
3 *Sentencing Act 1997* (Tas) s 88; *Sentencing Act 1991* (Vic) s 8D.
4 See *R v Kogelbauer* (1992) 65 A Crim R 357 (NSWCCA), 359 (Hunt CJ) where the author of a

pre-sentence report gave evidence to the Court. The parties must be given the opportunity to make submissions on the pre-sentence report: see *Slattery v Davis* (1993) 111 FLR 250; 65 A Crim R 116 (NTSC). In *R v Jensen* (1996) 87 A Crim R 241 (QCA), the Court of Appeal at 244 assumed that the author of the pre-sentence report could be cross-examined.

Victim Impact Statements

General

[12.13.460] At common law, injury or harm suffered by a victim can only be taken into account by a sentencer (see [12.13.140]) on sentencing in certain circumstances.[1] An offender's actions must be relevant to the offence for which the offender is to be sentenced.[2] Injury or harm is only a factor in determining the appropriate sentence if the injury or harm was foreseeable to the reasonable person.[3] Therefore, a sentencer cannot take into account injury to a victim which was not foreseeable by an offender.[4] State and Territory jurisdictions now recognise, to differing degrees, the usefulness of victim impact statements in assisting the court to determine an appropriate sentence:[5] see [12.13.480]–[12.13.550].

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1 See, eg, *R v Teremoana* (1990) 54 SASR 30; 49 A Crim R 207 (CCA).

2 See, eg, *R v Teremoana* (1990) 54 SASR 30; 49 A Crim R 207 (CCA), 37 (Cox J) (SASR).

3 *Feldman v Samuels* [1956] SASR 55; *Wise v The Queen* [1965] Tas SR 196 (CCA); *R v Boyd* [1975] VR 168 (FC), 172 (Gowans J); *R v McCormack* [1981] VR 104; (1980) 2 A Crim R 405 (CCA); *R v Wickham* [2004] NSWCCA 193, [25]; *Josefski v The Queen* (2010) 217 A Crim R 183; [2010] NSWCCA 41, [21].

4 *Feldman v Samuels* [1956] SASR 55; *R v Thompson* (1975) 11 SASR 217 (FC); *R v Boyd* [1975] VR 168 (FC), 172 (Gowans J); *R v Mallinder* (1986) 23 A Crim R 179 (VCCA). This has been reversed in Victoria by statute: *Sentencing Act 1991* (Vic) s 3(1) (definition of "victim"). See *Vanstone v The Queen* [2012] VSCA 142, [34]; cf *Josefski v The Queen* (2010) 217 A Crim R 183; [2010] NSWCCA 41, [68] (Howie J with Davies J agreeing at [38]).

5 State and Territory courts have jurisdiction with respect to Commonwealth offences: *Judiciary Act 1903* (Cth) s 68(2). *Judiciary Act 1903* ss 68(1), 79 and *Constitution* s 80 provide that State and Territory procedural laws apply to persons charged under Commonwealth law, including, by implication, procedures relating to sentencing. Although the Federal Court of Australia has had the procedural framework to deal with criminal offences since 2009, there are no provisions dealing with victim impact statements: see *Federal Court of Australia Amendment (Criminal Jurisdiction) Act 2009* (Cth).

Commonwealth

[12.13.470] State and Territory courts have jurisdiction with respect to Commonwealth offences,[1] and State and Territory procedural laws apply to persons charged under Commonwealth law.[2] Victim impact statements have been received by courts in relation to Commonwealth offences.[3]

The *Crimes Act 1914* (Cth) does not make express reference to victim impact statements but does require that:

(2) In addition to any other matters, the court must take into account such of the following matters as are relevant and known to the court:

…

(d) the personal circumstances of any victim of the offence;

(e) any injury, loss or damage resulting from the offence.[4]

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1 *Judiciary Act 1903* (Cth) s 68(2).
2 *Judiciary Act 1903* (Cth) ss 68(1), 79 and *Constitution* s 80 provide that State and Territory procedural laws apply to persons charged under Commonwealth law.
3 See, eg, *Weinert v Director of Public Prosecutions (Cth)* [1999] SASC 34; *Director of Public Prosecutions (Cth) v Hunter* (2003) 47 ASCR 464; [2003] VSCA 171.
4 *Crimes Act 1914* (Cth) s 16A.

Australian Capital Territory

[12.13.480] A sentencer (see [12.13.140]) in the Australian Capital Territory can only take a victim impact statement into account where the maximum penalty of the offence is at least one year's imprisonment or the offence is another offence specified in legislation.[1] A "victim" is defined to include a person who is financially or psychologically dependent on the deceased where the offence results in death,[2] but others may make victim impact statements. These include:

(1) a person with parental responsibility for the victim;

(2) a close family member;

(3) a carer of the victim; or

(4) a person in a close personal relationship with the victim.[3]

Victim impact statements should contain particulars of any harm suffered by a victim as a result of the offence.[4]

The court must take the statement into account when sentencing but must not draw any inference about the harm suffered by a victim because of the absence of a statement.[5] The defence may cross-examine the maker of a victim impact statement, but if an offender does not have legal representation, the offender may only do so if:

(a) the offender has indicated to the court the nature of the proposed cross-examination; and

(b) the court gives the offender leave to cross-examine the person.[6]

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1 *Crimes (Sentencing) Act 2005* (ACT) s 48.
2 *Crimes (Sentencing) Act 2005* (ACT) s 47 (definition of "victim").
3 *Crimes (Sentencing) Act 2005* (ACT) s 49.
4 *Crimes (Sentencing) Act 2005* (ACT) s 47 (definition of "victim impact statement").
5 *Crimes (Sentencing) Act 2005* (ACT) s 53(1).

6 *Crimes (Sentencing) Act 2005* (ACT) ss 53(3)–(4).

New South Wales

[12.13.490] In New South Wales, the formal requirements of a victim impact statement are identified.[1] The statement can be received and considered by the Supreme Court, Industrial Relations Commission, District Court or the Local Court, but the offences in respect of which the statement can be received vary depending on the court.[2] The statutory scheme is not a code and where the statutory scheme does not apply to particular offences, statements by victims may still be considered relevant and admissible to the sentencing process.[3]

The definition of "victim" expressly includes the immediate family of a deceased victim.[4] If the primary victim has died as a direct result of the offence, the court must receive a victim impact statement made by a family victim and may make any comment the court considers appropriate.[5] In that case however, if a victim impact statement only deals with the effect of the death on the family, the statement is not relevant to the quantum of the sentence.[6]

The absence of a victim impact statement does not give rise to the inference that an offence had little or no impact on a victim.[7] A representative of the victim may read out the statement in court.[8]

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1 *Crimes (Sentencing Procedure) Act 1999* (NSW) s 30.
2 *Crimes (Sentencing Procedure) Act 1999* (NSW) ss 27–28.
3 *Porter v The Queen* [2008] NSWCCA 145, [53] (Johnson J, Bell JA and McCallum J agreeing).
4 *Crimes (Sentencing Procedure) Act 1999* (NSW) s 26 (definitions of "family victim", "primary victim", "victim").
5 *Crimes (Sentencing Procedure) Act 1999* (NSW) s 28(3).
6 *R v Previtera* (1997) 94 A Crim R 76 (NSWSC), 86–87 (Hunt CJ); *R v Dang* [1999] NSWCCA 42, [24]–[26] (Adams J) ("the idea that it is more serious or more culpable to kill someone who has or is surrounded by a loving and grieving family than someone who is alone is offensive to our notions of equality before the law"); *R v Muddle* [2004] NSWSC 403, [39]–[40] (Bell J).
7 *Crimes (Sentencing Procedure) Act 1999* (NSW) s 29(3).
8 *Crimes (Sentencing Procedure) Act 1999* (NSW) s 30A.

Northern Territory

[12.13.500] In the Northern Territory, a prosecutor (see [12.13.150]–[12.13.160]) must present a victim impact statement where a victim consents to its presentation.[1] "Victim" is defined as a person who suffers harm arising from the offence, or a person who is a relative of, or who was financially or psychologically dependent on a deceased victim.[2] Another person may present a victim impact statement with the consent of the court.[3]

The legislation distinguishes between a victim impact statement (prepared by a victim) and a victim report (prepared by a prosecutor).[4] The author of a victim impact statement may be cross-examined about its contents, though an unrepresented offender may only do so with leave.[5] The absence of a victim impact statement or victim impact report does not give rise to "an inference in favour of an offender or against a victim".[6]

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1 *Sentencing Act 1995* (NT) s 106B(1).
2 *Sentencing Act 1995* (NT) s 106A (definition of "victim").
3 *Sentencing Act 1995* (NT) s 106B(3).
4 *Sentencing Act 1995* (NT) s 106A.
5 *Sentencing Act 1995* (NT) s 106B(9).
6 *Sentencing Act 1995* (NT) s 106B(6).

Queensland

[12.13.510] In Queensland, the *Victims of Crime Assistance Act 2009* (Qld) covers the provision of information to courts about the harm caused by an offence. Victims of a crime are permitted to give prosecutors details of the harm caused by the offence, for the purpose of sentencing.[1] Prosecutors can continue with a sentencing hearing without having details of the harm if it is reasonable to do so in the circumstances.[2] Prosecutors also have discretion on how to use the details of harm (whether or not given in the form of a victim impact statement) and may have regard to victims' wishes with respect to information that is to be withheld.[3]

Where information about the harm is to be given by means of a victim impact statement, this may be prepared by a victim or by another person if, by reason of a victim's age or capacity, the victim is unable to do so.[4] The fact that there is no information about the harm to a victim at the time of sentencing does not give rise to an inference that the offence caused little or no harm.[5]

For the purpose of the *Victims of Crime Assistance Act 2009*, s 5(1) defines a victim as

> a person who has suffered harm —
>
> (a) because a crime is committed against the person; or
>
> (b) because the person is a family member or dependant of a person who has died or suffered harm because a crime is committed against that person; or
>
> (c) as a direct result of intervening to help a person who has died or suffered harm because a crime is committed against that person.[6]

However a person who has committed a crime against a person is not a victim for the purpose of s 5(1)(a) or (b).[7]

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1 *Victims of Crime Assistance Act 2009* (Qld) s 15(1).
2 *Victims of Crime Assistance Act 2009* (Qld) s 15(2).
3 *Victims of Crime Assistance Act 2009* (Qld) ss 15(3)–(4).
4 *Victims of Crime Assistance Act 2009* (Qld) s 15(5).
5 *Victims of Crime Assistance Act 2009* (Qld) ss 15(6)–(7).
6 *Victims of Crime Assistance Act 2009* (Qld) s 5(1).
7 *Victims of Crime Assistance Act 2009* (Qld) s 5(2).

South Australia

[12.13.520] In South Australia, a trial court may be provided with a victim impact statement.[1] Victim impact statements may be received where there has been "injury, loss or damage" resulting from an indictable offence or a prescribed summary offence.[2] The prosecutor must provide particulars of any injury, loss or damage resulting from any offence to the court, unless the court is already in possession of such particulars,[3] or if the victim has asked the prosecutor not to give the information.[4]

The *Criminal Law (Sentencing) Act 1988* (SA) also allows for the provision of community impact statements. These cover written statements about the effect of the offence (or that type of offence) on:

(1) people living or working in the location in which the offence was committed (a neighbourhood impact statement); or

(2) the community generally or any particular sections of the community (a social impact statement).[5]

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1 *Criminal Law (Sentencing) Act 1988* (SA) ss 7A(1)–(4).
2 *Criminal Law (Sentencing) Act 1988* (SA) s 7A(1). A prescribed summary offence is defined in s 7A(5) as one resulting in death, total incapacity or, where the primary offence is not assault, results in a victim suffering serious harm.
3 *Criminal Law (Sentencing) Act 1988* (SA) s 7(1)(a).
4 *Criminal Law (Sentencing) Act 1988* (SA) s 7(2).
5 *Criminal Law (Sentencing) Act 1988* (SA) s 7B.

Tasmania

[12.13.530] Section 81A of the *Sentencing Act 1997* (Tas) provides for the tender and use of victim impact statements. Where a person is found guilty of an indictable offence, a victim of that offence can provide the court with a victim impact statement.[1] The court may allow another person to do so, where appropriate.[2] A court must allow a victim to read their statement to the court if they had requested to do so at the time the statement was given to the court.[3]

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1 *Sentencing Act 1997* (Tas) s 81A(2).
2 *Sentencing Act 1997* (Tas) s 81A(2A).
3 *Sentencing Act 1997* (Tas) s 81A(4) (or the person who prepared the statement or a nominee).

Victoria

[12.13.540] In Victoria, a victim impact statement may be in the form of a statutory declaration or oral evidence.[1] It includes particulars of any injury, loss or damage suffered by a victim as a direct result of the offence.[2] The statement may be made by another person where the victim is under the age of 18 years, or where the court is satisfied that the person is incapable of doing so, or where the victim is not an individual.[3] A medical report can be attached to a victim impact statement.[4] The harm includes injury, loss or damage not reasonable foreseeable by an offender.[5]

The report must be filed with the court and provided to the prosecution and defence a reasonable time before sentencing.[6] The victim, or a person who has made a victim impact statement on behalf of the victim, or an expert who has made a medical report may be called to give evidence, and may be cross-examined and re-examined.[7] There are also provisions dealing with the calling of witnesses and the reading out of the statement.[8]

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1 *Sentencing Act 1991* (Vic) ss 8K(2)(a)–(b).
2 *Sentencing Act 1991* (Vic) s 8L(1).
3 *Sentencing Act 1991* (Vic) s 8K(3).
4 *Sentencing Act 1991* (Vic) s 8M. A "medical expert" is defined as a medical practitioner, dentist or psychologist: s 8J.
5 *Sentencing Act 1991* (Vic) s 3(1) (definition of "victim").
6 *Sentencing Act 1991* (Vic) s 8N.
7 *Sentencing Act 1991* (Vic) s 8O.
8 *Sentencing Act 1991* (Vic) ss 8P–8S.

Western Australia

[12.13.550] In Western Australia, a victim impact statement includes not only the particulars of injury,[1] **but also the effect on the victim of the commission of the offence.**[2] If a victim is underaged, disabled, or otherwise personally incapable of giving the statement, someone else can do so if the court is satisfied that it is appropriate.[3] A psychiatrist's report can be attached to a victim impact statement.[4] The court may make a written impact statement available to the prosecutor and to the defence counsel.[5]

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1 *Sentencing Act 1995* (WA) s 25(1)(a).
2 *Sentencing Act 1995* (WA) s 25(1)(b).
3 *Sentencing Act 1995* (WA) s 24.
4 *Sentencing Act 1995* (WA) s 25(3).
5 *Sentencing Act 1995* (WA) s 26.

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Giving Reasons for Sentence

[12.13.660] There is a general common law principle that sentencers (see [12.13.140]) should give reasons for any sentence which they impose.[1] Those reasons must enable an appellate court to determine whether the judgment is wrong, and they are a reference point for the Parole Board.[2] The necessity of giving reasons is because of the interests of consistency and fairness to an offender and to the community, who are entitled to know the basis of any sentence.[3] Reasons are also necessary for an appeal court to determine whether the sentencer has failed in the exercise of any discretion.[4]

Full and detailed reasons do not need to be given in every case.[5] Sentencers need only indicate, in general terms, that they have considered alternatives and state short reasons for adopting the sentence.[6] If an option other than immediate imprisonment is realistically available, the reasons must reveal why such a sentence is not appropriate.[7] If the required reasons are not given, there is a miscarriage of the sentencing discretion.[8]

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1 *Pettitt v Dunkley* [1971] 1 NSWLR 376 (CA); *Nevermann v The Queen* (1989) 43 A Crim R 347 (WACCA).
2 *Nevermann v The Queen* (1989) 43 A Crim R 347 (WACCA), 354 (Brinsden J); *Lloyd v Faraone* [1989] WAR 154 (FC), 163 (Malcolm CJ).
3 Law Reform Commission, *Sentencing*, Report No 44 (1988) [163].
4 See *Tame v Fingleton* (1974) 8 SASR 507, where Walters J at 509–510 found that even though no reasons for a sentence are stated this does not mean that the sentence cannot stand. See *R v Smith* (1993) 69 A Crim R 47 (NSWCCA) where the Court found that where there is a dispute on the facts, and the sentencer fails to record their findings in relation to those facts, the sentencer has fallen into serious error.
5 *Nevermann v The Queen* (1989) 43 A Crim R 347 (WACCA), 350 (Malcolm CJ).
6 *Nevermann v The Queen* (1989) 43 A Crim R 347 (WACCA), 350 (Malcolm CJ).
7 *Hull v Western Australia* (2005) 156 A Crim R 414; [2005] WASCA 194, [31] (Roberts-Smith JA); *R v J C E* (2000) 120 A Crim R 18; [2000] NSWCCA 498, [19] (Fitzgerald JA); *R v CJP* [2003] NSWCCA 187, [63]–[65].
8 *Spreitzer v The Queen* (1991) 58 A Crim R 114 (WACCA), 120.

[12.13.670] In some jurisdictions, legislation requires reasons to be given in respect of certain aspects of sentencing. For example, s 17A(2) of the *Crimes Act 1914* (Cth) requires that where a court imposes a sentence of imprisonment for a federal offence, the court:

(a) shall state the reasons for its decision that no other sentence is appropriate; and

(b) shall cause those reasons to be entered in the records of the court.[1]

If a court imposing a federal sentence decides under s 19AC that a recognisance release order is not appropriate, reasons must be given.[2]

In the Australian Capital Territory, where a sentence of imprisonment is imposed, the court must explain to the offender why no other penalty is appropriate and the purpose of the sentence.[3] In addition, a court is required to record reasons for making or not making a particular order, such as an intensive correction order or community service order, where this would be contrary to a finding or recommendation of suitability or unsuitability in an assessment ordered by the court.[4] In New South Wales, the *Crimes (Sentencing Procedure) Act 1999* (NSW) requires reasons for decisions such as declining to set a non-parole period or giving a non-custodial sentence in circumstances where a standard non-parole period applies.[5] In the Northern Territory, reasons must be given where an indefinite sentence is imposed or for fixing or refusing to fix a non-parole period for an offence of murder.[6] In Queensland, the legislative provision is more general, and requires reasons to be given where a sentence of imprisonment is imposed.[7] In South Australia, a sentencer must inform an offender of the reasons for sentence when they are present in the court.[8] In Victoria, the court must state its reasons for imposing an indefinite sentence or "special reason" for imposing a minimum non-parole period, where such a period applies.[9] In Western Australia, where a term of imprisonment of less than a year is imposed, reasons as to why no other sentencing option is appropriate must be given.[10]

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1 See also *Crimes Act 1914* (Cth) s 16F.
2 *Crimes Act 1914* (Cth) s 19AC(5).
3 *Crimes (Sentencing) Act 2005* (ACT) s 82.
4 *Crimes (Sentencing) Act 2005* (ACT) ss 78(7), 89(6). See also ss 80D(6), 80J(5), 97(5), 117(4).
5 *Crimes (Sentencing Procedure) Act 1999* (NSW) ss 45(2), 54C.
6 *Sentencing Act 1995* (NT) ss 69, 53A(9).
7 *Penalties and Sentences Act 1992* (Qld) s 10(1).
8 *Criminal Law (Sentencing) Act 1988* (SA) s 9.
9 *Sentencing Act 1991* (Vic) ss 18G, 10A.
10 *Sentencing Act 1995* (WA) s 35.

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Appeal Courts

Role of Appeal Courts

General

[12.13.780] In all the States and Territories, an appeal against a sentence from a Supreme Court is dealt with by an appeal court.[1] In the Australian Capital Territory, Queensland, Victoria and Western Australia, the appeal is to the Court of Appeal.[2] In New South Wales, the Northern Territory and Tasmania, an appeal against a sentence is to the Court of Criminal Appeal.[3] In South Australia, it is to the Full Court of the Supreme Court of South Australia.[4]

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1 For some federal offences, an alternative route of appeal is the Full Court of the Federal Court. *Federal Court of Australia Act 1976* (Cth) s 30AA allows the Full Court of the Federal Court to hear appeals against sentence. Section 30AA was inserted by the *Federal Court of Australia Amendment (Criminal Jurisdiction) Act 2009* (Cth).

2 *Supreme Court Act 1933* (ACT) ss 37E, 37O(5); *Criminal Code* (Qld) Ch 67; *Criminal Procedure Act 2009* (Vic) Pt 6.3; *Criminal Appeals Act 2004* (WA).

3 *Criminal Appeal Act 1912* (NSW); *Criminal Code* (NT) Pt X Div 2; *Criminal Code* (Tas) s 401.

4 *Criminal Law Consolidation Act 1935* (SA) Pt 11.

[12.13.790] An appeal against a sentence to an appeal court usually requires the leave of the appeal court.[1] If leave is given by the appeal court, its role in relation to an offender's appeal against their sentence is to determine whether an error has been made in the exercise of the sentencing discretion, in accordance with the principle established in *House v The King*:

> It is not enough that the judges composing the appellate court consider that, if they had been in the position of the primary judge, they would have taken a different course. It must appear that some error has been made in exercising the discretion. If the judge acts upon a wrong principle, if he allows extraneous or irrelevant matters to guide or affect him, if he mistakes the facts, if he does not take into account some material consideration, then his determination should be reviewed and the appellate court may exercise its own discretion in substitution, for his if it has the materials for doing so. It may not appear how the primary judge has reached the result embodied in his order, but, if upon the facts it is unreasonable or plainly unjust, the appellate court may infer that in some way there has been a failure properly to exercise the discretion which the law reposes in the court of first instance.[2]

Essentially, the issue is whether an identifiable error is disclosed or whether the result is manifestly excessive or inadequate (see [12.13.800]) such that an undisclosed error of principle can be inferred.[3]

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1 *Criminal Appeal Act 1912* (NSW) s 5(1); *Criminal Code* (NT) s 410; *Criminal Code* (Qld) s 668D; *Criminal Law Consolidation Act 1935* (SA) s 352(1)(a); *Criminal Code* (Tas) s 401(1); *Criminal Procedure Act 2009* (Vic) s 274; *Criminal Appeals Act 2004* (WA) s 27. In the Australian Capital Territory, leave to appeal is required from interlocutory judgments: *Supreme Court Act 1933* (ACT) s 37E(4), but there is no express restriction on appeals from final judgments.

2 *House v The King* (1936) 55 CLR 499; 9 ABC 117 (HCA), 504–505 (CLR); *Cranssen v The King* (1936) 55 CLR 509; 10 ALJ 199 (HCA), 519–520 (CLR); *Harris v The Queen* (1954) 90 CLR 652; 28 ALJ 402 (HCA), 655 (CLR).

3 *Wong v The Queen* (2001) 207 CLR 584; 76 ALJR 79; [2001] HCA 64, [58] (Gaudron, Gummow and Hayne JJ).

Crown Appeals against Sentence

[12.13.800] In all the States and Territories, the Crown can appeal against a superior court sentence.[1] Crown appeals against sentence should only be brought in exceptional circumstances, to establish some matter of principle, correct a manifestly inadequate sentence, or maintain adequate standards of punishment.[2] An appeal court will only intervene if a sentencer (see [12.13.140]) has acted upon some wrong principle, a misunderstanding, or wrong assessment of the evidence.[3] Because of the common law principle against double jeopardy,[4] there is a residual discretion in the appeal court not to grant a Crown appeal where error is disclosed, even if the appeal court finds that the sentence was inadequate.[5] The discretion to interfere may not be exercised if the offender has completed the sentence and appears to be on the path to rehabilitation.[6]

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1 *Supreme Court Act 1933* (ACT) s 37E; *Criminal Appeal Act 1912* (NSW) s 5D; *Criminal Code* (NT) s 414; *Criminal Code* (Qld) s 669A; *Criminal Law Consolidation Act 1935* (SA) s 352(1)(a)(iii); *Criminal Code* (Tas) s 401(2); *Criminal Procedure Act 2009* (Vic) s 287; *Criminal Appeals Act 2004* (WA) s 24.

2 *Lacey v Attorney-General (Qld)* (2011) 242 CLR 573; 85 ALJR 508; 207 A Crim R 91; [2011] HCA 10, [15]–[17]; *Everett v The Queen* (1994) 181 CLR 295; 68 ALJR 875; 74 A Crim R 241, 299–300 (Brennan, Deane, Dawson and Gaudron JJ) (CLR); *Griffiths v The Queen* (1977) 137 CLR 293; 51 ALJR 749, 310 (CLR).

3 *R v Tait* (1979) 46 FLR 386 (FCAFC), 388 (Brennan, Deane and Gallop JJ).

4 *Criminal Law Principles* "Double Jeopardy" [9.1.3000]–[9.1.3370].

5 *Green v The Queen* (2011) 244 CLR 462; 86 ALJR 36; 214 A Crim R 152; [2011] HCA 49, [26] (French CJ, Crennan and Kiefel JJ), [131] (Bell J); *Bugmy v The Queen* (2013) 249 CLR 571; 87 ALJR 1022; 229 A Crim R 337; [2013] HCA 37, [24].

6 *R v Tindle* (unreported, NSWCCA, Spigelman CJ, Abadee and Ireland JJ, 60362 of 1998, 8 October 1998); *R v Atkins* (unreported, NSWCCA, Abadee, James and Barr JJ, 60451 of 1998, 3 November 1998). In both these cases, the Crown was criticised for not expediting the appeal when community service was imposed.

Role of High Court

[12.13.810] The High Court's appellate jurisdiction stems from s 73 of the

***Constitution*.** In relation to an appeal against a sentence, jurisdiction is given to hear and determine an appeal from the Federal Court of Australia and the Supreme Court of any State[1] or the Territories:[2] see [12.13.780]–[12.13.800]. The judgment of the High Court is "final and conclusive".[3]

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1 *Constitution* s 73(ii).
2 *Judiciary Act 1903* (Cth) s 35AA(1).
3 *Constitution* s 73.

[12.13.820] Special leave to appeal against a sentence to the High Court is necessary in all cases.[1] The High Court has stated that:

> [T]o warrant [the] grant of a special leave to appeal against a sentence when there has been no want or excess of jurisdiction, it must appear that the case involves some question of law or principle of general importance or that there has been a gross violation of the principles which ought to govern discretion in imposing sentence.[2]

It is rare, therefore, that special leave would be granted for the appeal against a sentence.[3] If special leave is granted and the appeal against the sentence is heard, the High Court may affirm, reverse or modify the judgment which is appealed.[4]

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1 *Judiciary Act 1903* (Cth) s 35AA(2) (in relation to appeals from the Supreme Courts of the Australian Capital Territory and the Northern Territory); *Judiciary Act 1903* (Cth) s 35(2) (in relation to the Supreme Court of a State).
2 *Lowe v The Queen* (1984) 154 CLR 606; 58 ALJR 414; 12 A Crim R 408, 609 (Gibbs CJ) (CLR).
3 *Veen v The Queen (No 1)* (1979) 143 CLR 458; 53 ALJR 305, 467 (Mason J) (CLR).
4 *Judiciary Act 1903* (Cth) s 37.

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Family Law

Introduction

As generally understood, Family Law concerns the regulation of family and domestic relationships, and the resolution of disputes arising from such relationships. These relationships may entail legal formalities, such as those attending the celebration or dissolution of marriage, or arising from the birth and care of children. In other cases they may be based upon a variety of informal living arrangements, whether involving de facto or same-sex partners, siblings, relatives, friends and the like. When domestic relationships founder, the matters in dispute typically include children (eg questions of parental responsibility and parenting arrangements for the future), financial issues (eg property division, financial agreements, adult maintenance and child support) and the need for protection of a partner or child from domestic violence, harassment or abuse.

In Australia, the relevant law dealing with family and domestic relationships is to be found in a mixture of federal legislation, State and Territory legislation, and in some cases, the common law. Under the *Constitution*, the federal government has no plenary power in relation to family law; rather its powers are generally limited to the topics of "marriage" and "divorce and matrimonial causes". However, since the *Family Law Act 1975* (Cth) came into operation in January 1976, the scope of federal family law has been expanding in a number of directions. This process of expansion received particular impetus with the reference to the Commonwealth by the Territories and most of the States in the late 1980s of certain powers in relation to children. Even so, there are significant areas of the law concerning children, such as child welfare law and adoption of children, which remain firmly the province of State (or Territory) legislation. Another reference of State and Territory legislative powers to the Commonwealth, this time in relation to financial aspects of de facto relationships, is currently under consideration. As a result of a successful constitutional challenge in 1999, the State-to-Commonwealth aspects of what is known as the cross-vesting system is no longer available to solve jurisdictional gaps or confusion as between federal and State courts, but it should be noted that in an appropriate case the Family Court of Australia may exercise accrued jurisdiction over issues of State law which are intimately and inseverably connected to a matter arising under the *Family Law Act 1975*.

The purpose of this Title is to provide a succinct account of the guiding principles underlying the most important aspects of family law, as outlined above. After the introductory 17.1 "Jurisdiction" [17.1.1]ff, 17.2 "Professional ethics" [17.2.1]ff deals with questions of legal ethics in family law matters. The law of marriage and divorce is covered in 17.3 "Marriage and nullity" [17.3.1]ff and 17.4 "Divorce" [17.4.1]ff. This is followed by a discussion of the legal remedies relevant in situations of domestic violence between current or former domestic partners: see 17.5 "Domestic violence" [17.5.10]ff. A number of important areas of law concerning children are dealt with, namely principles relating to the status of children and the notion of parental rights (see 17.6 "Status of children and parental rights and responsibilities" [17.6.1]ff), disputes over parental responsibility and parenting orders (see 17.7 "Parenting orders and related matters" [17.7.10]ff), the abduction of children to or from overseas (see 17.8 "International child abduction" [17.8.1]ff), the legal adoption of children (see 17.9 "Adoption of children" [17.9.1]ff), child welfare "care" proceedings in relation to abused or neglected children (see 17.10 "Child welfare" [17.10.1]ff) and financial support for children: see 17.11 "Child support" [17.11.1]ff.

Turning to questions of financial adjustment arising from marital relationships, the principles of financial support of adults on marital breakdown or divorce are dealt with in 17.12 "Spousal maintenance" [17.12.10]ff. The law relevant to property division and financial agreements between spouses or former spouses is found in 17.13 "Property: general principles" [17.13.1]ff, 17.14 "Alteration of property interests" [17.14.1]ff, 17.15 "Valuation of property and tax and revenue issues" [17.15.1]ff and 17.16 "Financial agreements and consent arrangements" [17.16.1]ff. A discussion of financial matters arising from non-marital domestic relationships is given in 17.17 "Property and financial adjustment in de facto and domestic relationships" [17.17.1]ff. The basic principles governing the issue of injunctions and restraining orders for the protection of parties to domestic relationships and of children is covered in 17.18 "Injunctions" [17.18.1]ff. Finally, 17.19 "Family Court orders" [17.19.1]ff focuses on the enforcement of orders made in proceedings under the *Family Law Act 1975*.

Owen Jessep

August 2007

Family Law

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Introduction

Definition

[17.15.1] The Family Court's powers in relation to financial matters are set out in Pts VIII, VIIIAA, VIIIAB Divs 3, 4 and VIIIB of the *Family Law Act 1975* (Cth). Essentially these parts of the Act are concerned with:

(1) the division of property (including superannuation interests) between spouses (including de facto couples);[1] and

(2) the determination of any maintenance entitlements and obligations.

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1 *Family Law Amendment (De Facto Financial Matters and Other Measures) Act 2008* (Cth).

[17.15.2] The objective of property orders made under the *Family Law Act 1975* (Cth) is to be just and equitable. As a result, there is no clear cut dividing line between the apportionment of assets and the determination of maintenance as the two issues overlap to some degree. For example, the Family Court might allocate a higher proportion of net assets to one spouse in recognition of the needs of that spouse as custodial parent and/or because of the relative inability of that spouse to earn sufficient income to adequately support them.

[17.15.3] "Property" includes every possible interest, asset or thing of value that either party has or can have. [1] The definition of property is very wide and includes almost anything of value. Property can come within the scope of the *Family Law Act 1975* (Cth) even if the entitlement is a reversionary interest. That is, the property need not be in the possession of the party or parties.[2]

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1 *In Marriage of Duff* (1977) 29 FLR 46 (FamCAFC); *Jones v Skinner* (1835) 5 LJ Ch 87, 90 (Lord Longdale MR). See also *In Marriage of Best* (1993) 116 FLR 343.

2 *In Marriage of Duff* (1977) 29 FLR 46, 56 (FamCAFC).

[17.15.4] An interest in a superannuation fund is treated as "property" and may affect the allocation of property.[1] Part VIIIB of the *Family Law Act 1975* (Cth) was inserted in 2001[2] to allow certain payments (splittable payments) in respect of a superannuation interest to be allocated between the parties to a marriage, either by agreement or by court order.[3] In 2008, this allowance was extended to include de facto couples as well.[4]

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1 *Family Law Amendment (De Facto Financial Matters and Other Measures) Act 2008* (Cth) s 53

created a new s 90MC(2) in the *Family Law Act 1975* (Cth).
2 By *Family Law Legislation Amendment (Superannuation) Act 2001* (Cth) s 4.
3 *Family Law Act 1975* (Cth) s 90MA (under Pt VIIIB).
4 See *Family Law Amendment (De Facto Financial Matters and Other Measures) Act 2008* (Cth) s 51.

[17.15.5] Property orders that can be made under the *Family Law Act 1975* (Cth) are far reaching. Examples include:

(1) sale of the property;

(2) partition of the property;

(3) interim or permanent orders as to possession;[1]

(4) payment of money; and

(5) ancillary orders under s 80(1) of the Act.[2]

In addition, Pt VIIIAA of the Act enables orders and injunctions to be binding on third parties.[3]

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1 *Family Law Act 1975* (Cth) s 78(2).
2 *Family Law Act 1975* (Cth) s 80.
3 *Family Law Act 1975* (Cth) s 90AA.

[17.15.6] The determination of each party's assets and liabilities, in practice, is not always a relatively straight forward matter. Determining assets and liabilities may be difficult because of:

(1) the lack of financial sophistication of one or both parties;

(2) the inadvertent omission of assets or liabilities (many people forget, eg to allow for liabilities that have accrued, but have not yet been invoiced, eg utility bills);

(3) disputes as to value;

(4) measurement difficulties, in particular, of income tax and capital gains tax liabilities;

(5) inter entity assets and liabilities (eg an investment portfolio of a spouse may be financed by a loan from a family company. Some practitioners add the value of the investment portfolio and the loan asset, but fail to deduct the spouse's loan liability); and

(6) totally unrealistic values are often attributed to business assets, particularly goodwill. This problem is frequently exacerbated by the financial self interest of one or both parties, and errors in the valuation reports obtained.

[17.15.7] Financial matters should be set out in affidavit format including statements of all assets and liabilities[1] and in valuation reports for material assets such as shares, property and collectibles.[2] The objective is to provide both parties with the full factual position. This avoids disinformation, minimises (so far as is possible to do) misunderstandings and should encourage out of court settlements.

A Financial Statement must be completed and filed with the initial application.[3] If a party's financial circumstances change significantly from the information set out in the initial Financial Statement or the affidavit filed the party must, within 21 days after the change of circumstance, file:

(1) a new Financial Statement; or

(2) if the amendments can be set out clearly in 300 words or less – an affidavit containing details about the party's changed financial circumstances.[4]

The form of the financial statement is prescribed by the Federal Court of Australia and the Family Court of Australia.

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1 *Family Law Rules 2004* (Cth) r 13.04.
2 *Family Law Rules 2004* (Cth) r 12.02.
3 *Family Law Rules 2004* (Cth) r 13.05.
4 *Family Law Rules 2004* (Cth) r 13.06.

[17.15.8] The relevant valuation date is at or near to the final hearing date. [1] The valuation at date of separation may be relevant in some cases (eg where a party has dissipated their assets) and these cases have to be determined upon the relevant facts.[2] However, in disputed or protracted cases, it may be necessary to obtain an updated valuation. Thus it is prudent practice to negotiate valuation fees including a possible update when the initial valuation assignment is agreed.

It is important to note that assets acquired "post-separation" are not necessarily protected: see [17.15.223]–[17.15.237].

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1 *In Marriage of Wardman and Hudson (formerly Wardman)* (1978) 33 FLR 196, 200 (FamCAFC); *In Marriage of Geyl* (1978) 7 Fam LR 219, 223, 224 (FamCAFC); *In Marriage of Quinn* (1979) 37 FLR 168, 173 (Evatt CJ) (FamCAFC); *In Marriage of Warne* (1982) 8 Fam LR 388 (FamCAFC); *In Marriage of Hauff* (1986) 10 Fam LR 1076 (FamCAFC); *In Marriage of Gamer* (1988) 12 Fam LR 73 (FamCAFC).
2 *In Marriage of Cozanitis* (1979) 4 Fam LR 709 (FamCAFC); *In Marriage of Currie* (1976) 26 FLR 469 (FamCAFC); *In Marriage of Hayne* (1977) 30 FLR 533, 534 (Powley SJ) (FamCA); *In Marriage of Healy* [1977] FLC 90-295; *In Marriage of Lange and Moores* [1979] FLC 90-651 (FamCA); *In Marriage of Mackie* (1981) 7 Fam LR 365 (FamCA); *Vincent v Smith* [2005] TASSC 103, [19] (Master Holt).

[17.15.8.1] In the case of a marriage or relationship of short duration it may be relevant to consider the value of the property contributed.[1] If a party contributed an asset or assets of significant value at the commencement of the marriage or relationship this contribution may be taken into account when assessing the parties' relative contributions and the allocation of property interests. Valuation evidence may be required in this regard.[2] Where the financial relationship of the parties during the marriage was such that they treated some property as exclusively the property of one party to which the other party made no contributions, an asset by asset approach may be more suitable.[3]

1 *In Marriage of Quinn* (1979) 37 FLR 168, 169 (Evatt CJ).
2 *Harle v Harle* [2008] FamCA 825.
3 *In Marriage of Zyk* (1995) 128 FLR 28, 32–33 (cited in *Elliott v Elliott* [2007] FamCA 1232, [27] (O'Reilly J)).

[17.15.9] In all cases it is desirable from a cost perspective that the relevant parties agree on how assets should be valued. Family law matters are frequently highly emotionally charged and given the potentially high cost of proceedings, valuation and tax advice should be considered carefully relative to the range of values that are legitimately in dispute.

Scope of Subtitle

[17.15.11] This Subtitle discusses valuation, tax and revenue issues that arise in family law matters. General valuation principles, the definition of value, and the various valuation methodologies available are examined in [17.15.13]–[17.15.92]. The valuation of controlling interests in a company is the focus of [17.15.94]–[17.15.108]. For the valuation of minority interests in companies, see [17.15.109]–[17.15.144]. The valuation of partnerships and professional practices is discussed in [17.15.145]–[17.15.162]. For the valuation of residential and commercial properties, valuation techniques, the role of expert valuers and the valuations of options to purchase property, see [17.15.163]–[17.15.190]. The valuation of liabilities of spouses and their businesses is discussed in [17.15.191]–[17.15.222.3]. The valuation of identifiable intangible assets, such as brand names and licences is dealt with in [17.15.222.7]–[17.15.237]. The valuation of franchises is discussed in [17.15.238]–[17.15.246], and the valuation of interests in trusts in [17.15.247]–[17.15.279.1]. The valuation of personal assets is focussed on in [17.15.280]–[17.15.285]. Finally, capital gains tax and other tax liabilities, such as income tax, are examined in [17.15.286]–[17.15.329].

Related Titles and Subtitles

[17.15.12] There are a number of Titles and Subtitles which are concerned with matrimonial property. The meaning of the term "property" under the *Family Law Act 1975* (Cth) and the jurisdiction of courts to entertain property proceedings and declarations of property interests under the Act are discussed in "Property: General Principles" [17.13.10]ff. Alteration of property interests, the variation and setting aside of orders altering property interests, and the ability of courts to deal with property that forms the subject of ante-nuptial or post-nuptial settlement is considered in "Alteration of Property Interests" [17.14.10]ff. Property proceedings between de facto partners is addressed in "Property and Financial Adjustment in De Facto and Domestic Relationships" [17.17.10]ff. Financial agreements and consent arrangements by parties to a marriage in relation to property are considered in "Financial Agreements and Consent Arrangements" [17.16.10]ff. Other relevant Titles include 31 *Revenue Law* for discussions on income tax, capital gains tax and goods and services tax, and 15 *Equity* for discussion of trusts and trust property.

[The next text page is 201]

Valuation of Residential and Commercial Properties

General

[17.15.163] Market value for the purpose of property valuation is defined by the International Valuation Standards Committee based on the hypothetical willing buyer and willing seller principle: see [17.15.24]. It is defined to be:

> The estimated amount for which an asset or liability should exchange on the valuation date between a willing buyer and a willing seller in an arm's length transaction after proper marketing where the parties had each acted knowledgeably, prudently and without compulsion.[1]

This definition of market value can be applied to both residential and commercial property.

1 International Valuation Standards Committee, *Glossary* 2017, <https://www.ivsc.org/standards/glossary>.

[17.15.164] Market value (see [17.15.163]) is not confined to the value of a property in its current condition and based on its current use but on the basis of its anticipated "highest and best use". The concept of "highest and best use" is a generally accepted property valuation principle that has been in existence for many decades and is implicit in the definition of market value. In *Spencer v Commonwealth* (1907) 5 CLR 418, the highest and best use principle was spelt out by Isaacs J who quotes Cockburn CJ from *R v Brown* (1867) 2 QB 630 as follows:

> [C]onsider the real value of the land, and … take into account not only the present purpose to which the land is applied, but also any other more beneficial purpose to which in the course of events at no remote period it may be applied, just as an owner might do if he were bargaining with a purchaser in the market. That is the mode in which the land would be valued.[1]

The principle is adopted by various courts and tribunals eg, The Administrative Appeals Tribunal in *Re Woodhouse and Secretary, Department of Social Security* (1987) 12 ALD 474. After considering the decisions in *Spencer v Commonwealth* and *R v Brown*, the Tribunal said:[2]

> In particular, both cases are authority for the propositions that in assessing market values one must ascertain the highest and best use of the property and assess the price that a desirous buyer would pay to a willing but not anxious seller to purchase the property.

The Family Court further explored the authorities for "highest and best use" in *Grieves v Grieves* (2012) 49 Fam LR 442; [2012] FamCA 691.[3] The Court noted that:

> As the authorities confirm, "highest and best use" is generally controversial when a change from existing use to a more beneficial use gives rise to a higher rather than to a lower valuation.[4]

It is commonsense and economic logic that if a property is valued using less than the optimal cash flows associated with the highest and best use of a property an arbitrage opportunity would arise. A buyer could acquire the property at the lower value, convert it to its highest or best use and resell it at a substantial profit. This profit would be a "super profit" or an amount that is over and above the normal profit that would be earned from investing in the property.

Expressed another way, if highest and best use principles are not applied then the value of the property would be artificially depressed. It would be open for someone to simply buy the property and remove this artificial depressing effect.

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1 *R v Brown* (1867) 2 QB 630, 631 (Cockburn CJ), cited by Isaacs J in *Spencer v Commonwealth* (1907) 5 CLR 418, 441.

2 *Re Woodhouse and Secretary, Department of Social Security* (1987) 12 ALD 474, 477 (the Tribunal).

3 *Grieves v Grieves* (2012) 49 Fam LR 442; [2012] FamCA 691, [31] (Coleman J) referring to *Spencer v Commonwealth* (1907) 5 CLR 418; *Brisbane City Council v The Valuer-General for the State of Queensland* (1978) 140 CLR 41; *Housing Commission (NSW) v San Sebastian Pty Ltd* (1978) 140 CLR 196; *Federal Commissioner of Taxation v St Helens Farm (ACT) Pty Ltd* (1981) 146 CLR 336; *The Valuer-General v Fenton Nominees Pty Ltd* (1982) 150 CLR 160; 56 ALJR 778; 47 LGRA 95.

4 *Grieves v Grieves* (2012) 49 Fam LR 442; [2012] FamCA 691, [34] (Coleman J).

[17.15.165] There are inherent difficulties in determining the value of many property assets because land and buildings are not generally traded frequently, and each property will usually have at least some unique characteristics such as its size, design, aspect and location. This is particularly the case for non-residential properties. As such, valuations are often ultimately based on a valuer's judgment. The element of "professional" judgment appears to be more noticeable in property valuations than, eg equity valuations which have the appearance of greater mathematical precision. It is this element of judgment that caused many disputes in family law cases. However, in "house and garden" cases the use of single experts reduces the disparities.

Valuation Techniques

Overview

[17.15.166] There are six common methods of valuation applied in valuing property. These are:

(1) comparable sales (see [17.15.167]);

(2) capitalisation of income (see [17.15.168]);

(3) discounted cash flow (see [17.15.169]);

(4) summation method (see [17.15.170]);

(5) hypothetical development (see [17.15.171]–[17.15.172]); and

(6) units of production: see [17.15.172].

Comparable Sales

[17.15.167] The comparable sales method is reliable and simple to apply where contemporaneous sales evidence of sufficiently comparable properties is available. A property may be comparable to another property because they share similar physical attributes (eg, two three-bedroom home units in similar buildings and locations) or because the particular type of property is sold on a unit basis, eg, value per square metre.

Residential properties are usually valued on the basis of comparable sales of properties with similar physical attributes. The type of properties likely to be valued on a unit basis is discussed at [17.15.172]. Determination of what actually is a "comparable sale" needs to be done with some care. As the trial judge stated in *In Marriage of Georgeson* (1995) 19 Fam LR 302, when using comparable sales to value property:

> There may be circumstances such as a sale by a mortgagee and this is a matter which suggests caution and investigation because the forced sale could result in a sale price lower than fair market value. On the other hand there are circumstances where prices may be paid above current market values and one such circumstance is where the sale is on unduly liberal terms and conditions.[1]

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1 *In Marriage of Georgeson* (1995) 19 Fam LR 302 (FamCAFC), 311 (the Court) citing the trial judge.

Capitalisation of Income

[17.15.168] Income producing properties are generally valued by capitalising the net rental income the property produces, before tax, at a capitalisation rate (often referred to as a "running yield"). The capitalisation rate is based on yields reflected in contemporaneous sales of comparable income producing properties. For example, if an office building generated net rental income (before tax) of $8 million per annum and the prevailing capitalisation rate was 8%, then the building would have a value of $100 million. This valuation method assumes a continuation of current rental income, the potential for rental and capital growth, the risks associated with investing in the property and any tax deductions available to an owner of the building, are all reflected in the yield.

This method is relatively easy and inexpensive to apply. It is also the method favoured by many property valuers with a real estate background. Valuers with a capital markets background generally prefer to use the discounted cash flow basis of valuation: see [17.15.73].

Discounted Cash Flow

[17.15.169] The discounted cash flow valuation method (see [17.15.73]) involves

calculating the present value of future cash flows. The use of discounted cash flows is particularly suited to properties with complicated or variable cash flows. The discount rate used may be based on the discount rates implicit in comparable transactions or calculated by using more formal models which calculate the discount rate based on the risk-free rate plus a margin for risk.

Summation Method

[17.15.170] The summation method involves the addition of the value of the constituent parts of the property to determine the value of the property as a whole. For example:

Summation method	**$000**
Land	1,000
Buildings thereon (at depreciated replacement cost)	2,000
Other improvements (fences, dams, etc)	*500*
	3,500

The summation method is generally less reliable as a primary valuation method due to the difficulty of identifying "comparable" sales of the constituent parts as they are rarely traded on a stand alone basis and the difficulty of assessing functional and technical obsolescence of the improvements. There may also be some synergistic benefits or detriments in the combination which are not reflected in the sum of the constituent parts.

Hypothetical Development

[17.15.171] The hypothetical development method is a discounted cash flow based valuation: see [17.15.169]. It is applied to properties whose value on the basis of highest and best use (see [17.15.164]) is higher than their value based on their existing condition and use such as:

(1) undeveloped land where highest and best use value would be derived by subdividing the land into individual building blocks;

(2) underdeveloped sites with potential for further development; and

(3) commercial or office sites where the existing buildings could be demolished and a new building constructed utilising the full benefit of the allowable site ratio.

The hypothetical development method of valuation involves a number of key assumptions, including:

(1) time and costs involved in the construction;

(2) an appropriate allowance for profit and risk;

(3) the yields, and hence value, prevailing at the time of completion; and

(4) future rental values following completion.

In the case of a development property, owned or acquired with the intention of constructing a building thereon and thereafter selling it, the future benefits expected to be derived from ownership of the property are reflected in the cash flows associated with the construction and development costs, financing costs, and net proceeds from the sale. In order to incorporate the proceeds from selling the building in the discounted cash flow model, it is necessary to calculate the potential sales value of the development once it is completed. This is done either by reference to the future cash flows expected to be derived from leasing the space in the completed building or by calculating the capital value of those cash flows to arrive at a value on completion, or exit value, of the developed property.

Units of Production Method

[17.15.172] The units of production method is used for valuing both rural properties (eg, dollar value per dairy cow able to be carried on the land) and for urban properties (eg, dollars per room for hotels, or per licensed bed for hospitals and nursing homes). The units of production basis is more akin to a rule of thumb basis of valuation applied in other industries and may be of very limited reliability due to other key factors which affect profitability and cash flow and hence value.

Residential Property

General

[17.15.173] Residential properties are normally valued based on contemporaneous sales of comparable residential properties (see [17.15.167]) but may be valued using one of the other methods of valuation in appropriate circumstances. Residential property is often the largest asset of a marriage, and as a result, has been the subject of much dispute in the Family Court.

Role of Expert Valuer

[17.15.174] Case law has shown that a trial judge will usually take into account the opinions of expert valuers in determining the value of residential property. This is consistent with the valuation of property other than real property. Until the single expert regime, both the husband and the wife normally used their own expert valuer to determine the value of the family's property or properties. There was then a need to assess one valuer's opinion of value over the other.

The role of the expert valuer was outlined in *In Marriage of Lenehan* (1987) 11 Fam LR 615, where the Court stated:

> A trial judge, as part of his ultimate responsibility under s 79 [of the *Family Law Act 1975* (Cth)] or otherwise, is normally required to determine a number of issues. Some of those issues may properly attract the evidence of expert witnesses. In appropriate circumstances their opinions are admissible to

> assist in the determination of such an issue. It is the responsibility of the trial judge to take into account the opinions of such witnesses … The expert evidence is called to enable the judge to form his own independent judgement on the matter by the application of the appropriate principles.[1]

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1 *In Marriage of Lenehan* (1987) 11 Fam LR 615 (FamCAFC), 619 (the Court) (cited as precedent in *Eaton v Eaton* [2013] FamCAFC 106, [189] (Finn, Strickland and Kent JJ).

Different Valuations of Same Property

[17.15.175] Two valuers of the same property will rarely, if ever, come to exactly the same conclusions regarding the value of a property. In *In Marriage of Essey* (unreported, FamCAFC, 9477 of 1991, 7 September 1993), the trial judge noted "[v]aluation, by its nature, is not a discipline which lends itself to precision".[1] This is due to the significant reliance on the judgment of the valuer, so it becomes a matter for the court to determine which valuer appears to present the most believable case to support his or her assessment of value.

The court is well aware of the level of subjectivity involved in property valuation. For example, in relation to the use of comparable sales as a valuation method (see [17.15.167]), the Court in *In Marriage of Georgeson* (1995) 19 Fam LR 302 stated that:

> [I]n adopting this [comparable sales] method of valuation, the valuer must rely to a degree on his own skill and judgement in assessing the utility of transactions in the market because comparable sales do not always reveal precise information and no two parcels of land are identical in all respects.[2]

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1 *In Marriage of Essey* (unreported, FamCAFC, 9477 of 1991, 7 September 1993), [37] (the Court); see *In Marriage of Smith* (1991) 102 FLR 359 (FamCAFC).

2 *In Marriage of Georgeson* (1995) 19 Fam LR 302 (FamCAFC), 308 (the Court).

[17.15.176] The level of care taken by a valuer will influence a judge's decision on whether to rely on one valuer over the other or upon the single expert. In *In Marriage of Davut and Raif* (1994) 118 FLR 205, the husband's valuer's opinion was disregarded by the trial judge because the two valuation reports prepared by the husband's valuer contained unexplained differences, mathematical errors, and in one of the valuations that he prepared, part of the property in question (the land) was not considered at all.[1]

The method adopted by the trial judge was that of the wife's valuer, whose:

> [M]ethod of valuation used in estimating the value of this property in question is the consideration of the sale prices of similar properties in that area. The condition of the houses has also been taken into consideration.[2]

In *Garden v Gavin (No 2)* (2010) 43 Fam LR 383; [2010] FamCAFC 125 the Full Court held that reliance by the husband's evidence of a kerbside evaluation was not evidence upon which the Federal Magistrate could have made a determination. In a letter to the husband, the real estate agent indicated that his valuation was arrived at by comparison with recent sales in the area of similar property and that he had driven by the property in question. The Full Court[3] stated:

> It is clear that Mr C had no knowledge of the property itself, such as the number of bedrooms or bathrooms. The comparable sales identified by Mr C were of high set brick properties with "4 bed + ensuite 2 bath, 2 car".
>
> It is apparent Mr C had no knowledge of the house as he had only "driven by" the property. It was impossible for him to value it based on those comparative properties.

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1 *In Marriage of Davut and Raif* (1994) 118 FLR 205 (FamCAFC), 214–215 (the Court).

2 *In Marriage of Davut and Raif* (1994) 118 FLR 205 (FamCAFC), 215 (the Court).

3 *Garden v Gavin (No 2)* (2010) 43 Fam LR 383; [2010] FamCAFC 125, [92]–[93] (Faulks DCJ, May and Benjamin JJ).

[17.15.177] The assumptions made by a valuer, usually in the choice of comparable sales (see [17.15.167]) and assessment of the overall property market will usually undergo probing cross-examination to highlight to a judge any weaknesses in the valuer's report. In *In Marriage of Nedelkovski* (unreported, FamCAFC, 4497 of 1990, 12 October 1992), the husband appealed on the ground that the trial judge had erred in rejecting the valuation evidence of the husband. The valuer for the husband found the former matrimonial home to be worth $123,500, and the wife's valuer found the value to be $180,000, which was accepted by the trial judge.[1] The two main reasons given by the trial judge for dismissing the husband's valuer were that the valuer took into account sales of properties that were not truly comparable to the property in question, as they were all inferior properties, and that the valuer's assessment was overly influenced by his pessimistic view of the current economic climate.[2] This was affirmed by the Full Court on appeal, and the appeal was dismissed.

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1 *In Marriage of Nedelkovski* (unreported, FamCAFC, 4497 of 1990, 12 October 1992), 10 (Lindenmayer J).

2 *In Marriage of Nedelkovski* (unreported, FamCAFC, 4497 of 1990, 12 October 1992), 11, 12 (Lindenmayer J).

[17.15.178] Whilst the parties may reach a compromise with respect to differing valuation, a trial judge cannot simply "average" two (or more) valuations given by valuers for the respective parties. In *Commonwealth v Milledge* (1953) 90 CLR 157 it was noted by the High Court that the correct approach to be applied by a trial judge in relation to a valuation issue is:

> [B]y a common sense endeavour, after consideration of all the material before the court, to fix a sum satisfactory to the mind of the court as representing the value contained in the land.[1]

In this case six experienced and professional valuers were used to value land (three from each side to the dispute). The High Court found that the Supreme Court judge was incorrect in averaging the valuations provided by each of the valuers. Their reasoning was:

> Even if all the witnesses [the valuers] had used the same material as one another, and had approached the problem in the same way, the average of the values they respectively reached would most likely be a figure which each of them would consider to be wrong. But what is worse is that it would be a figure not arrived at by the application by the court of the established principles of valuation.[2]

An example of where a trial judge averaged two valuations was in *In Marriage of Essey* (unreported, FamCAFC, 9477 of 1991, 7 September 1993). The trial judge found the correct value of a property at $135,000, after averaging the valuations prepared for either side, which were for $130,000 and $140,000. The decision was overturned on appeal based on *Commonwealth v Milledge* as well as *In Marriage of Lenehan* (1987) 11 Fam LR 615.[3]

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1 *Commonwealth v Milledge* (1953) 90 CLR 157, 162 (Dixon CJ and Kitto J).
2 *Commonwealth v Milledge* (1953) 90 CLR 157, 161 (Dixon CJ and Kitto J).
3 *In Marriage of Lenehan* (1987) 11 Fam LR 615 (FamCA).

[17.15.179] A judge does not have to choose the valuation of one valuer over the other, but can arrive at their own valuation based on the evidence.[1] As noted by a federal Magistrate, as long as:

> "proper principles" are applied, finding between two competing valuations may be permissible. This may for example, result from adoption of a property methodology but a different reliance on sales evidence before the court (or for a business, adopting one capitalisation rate over another). When a determination of values may not be possible on the evidence to order a sale may be the "proper solution".[2]

In *In Marriage of Davies* (1995) 129 FLR 1, the Full Court of the Family Court did not disturb the valuation arrived at by the trial judge which was an amalgamation of some features of each of the competing valuations before him. However, it referred the matter back to the trial judge in relation to one matter. The trial judge in this case did not entirely favour the opinion of either valuer in all respects.

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1 As demonstrated in *In Marriage of Smith* (1991) 102 FLR 359 (FamCAFC).
2 Michael Baumann, "Preparing and Presenting a Property Case in the Federal Magistrates Court" [2005] *Federal Judicial Scholarship* 1.

[17.15.180] Where the state of the evidence makes the process of valuation uncertain, or where there are wide differences between valuations which make the ascertainment of value by the court too uncertain, the preferable course is to order the sale of the property. In the case of *In Marriage of Smith* (1991) 102 FLR 359, the Full Court of the Family Court found that the trial judge agreed with neither the value of the husband's nor the wife's valuer but did not have sufficient evidence to arrive at his own value. In these circumstances the trial judge felt obliged to arrive at a valuation and valued the property based on the valuation of the husband's valuer, adjusted for realisation costs. He was not invited by either party to consider the issue of a sale and did not do so. The Full Court upheld the appeal and remitted the matter for rehearing.

Court-determined Value May Not Be Required

[17.15.181] A key issue addressed in *In Marriage of Nedelkovski* (unreported, FamCAFC, 4497 of 1990, 12 October 1992) **was that when, in all likelihood, a property will have to be**

sold to settle the interests of both parties, the orders of the trial judge in relation to the value of the property will not be critical. This is because a property will more than likely sell for a different amount to what the determined value was at the time of trial. If the trial judge allocates the settlement on fixed dollar amounts, rather than on a percentage of the value received for assets sold, one party to the agreement can be left with a large liability to the other party if the amount actually received on disposal of an asset (usually residential property) is much less than the value determined at the time of the trial.

Over time, case law has established general guidelines that the court should make orders giving each party a percentage of the value of sale proceeds of property rather than a fixed dollar amount.[1]

This issue was addressed in *In Marriage of Waters* (1981) 6 Fam LR 871 where the Court addressed the two alternative approaches:

> Although each case has to be considered on its own individual merits, in relation to property proceedings of this type as a generality a proper approach would involve the following:
>
> (a) Generally, it is preferable to make orders which give to each party a percentage of the current value of the property rather than a fixed amount. This is especially so where a future sale is proposed as there may be delays in carrying into effect such an order; and
>
> (b) It may well be proper to order a fixed amount in a particular case provided there is available a proper and recent valuation and it is clear from the orders that such an amount is to be paid within a relatively short period of time.[2]

In *In Marriage of Bell* (1992) 111 FLR 332, the Court considered this issue, and stated:

> There is always uncertainty in relation to the amount which will ultimately be obtained in respect of the sale of matrimonial property, and in particular, matrimonial real estate … [and that] where a sale of property is necessary to satisfy a lump sum order for settlement of property and the calculation of any lump sum payable arises from a finding as to the value of the property to be sold, then the amount to be paid to one or other of the parties following any such sale should be expressed in percentage terms, rather than by way of lump sum payment, unless good and sufficient reasons are given for doing so.[3]

In the case of *In Marriage of Little* (1990) 100 FLR 322, the Court also dealt with the issue of whether the trial judge should ascribe a value to a property, or allocate a percentage of money received to both parties, once the property is sold. The case involved a dispute over the value of the former matrimonial home and two other properties. The wife's valuer valued the former matrimonial home at $325,000 and the husband's valuer found that the home was worth $500,000. The trial judge found that "(he was) not satisfied that either valuation is the proper value, having regard to the state of the existing market".[4]

Further, the trial judge ordered that the only fair and proper way to determine the value of the home was to auction it.[5] This order was affirmed on appeal, where the Full Court found that:

> [I]n a case where there is a very considerable disparity in the valuation evidence and other evidence indicates that the actual ascertainment of the true value is difficult and complex, the proper solution as between the parties may be to order a sale.[6]

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1 See *In Marriage of Waters* (1981) 6 Fam LR 871 (FamCAFC); *In Marriage of Docters Van Leeuwen*

(1990) 100 FLR 261 (FamCAFC); *In Marriage of Bell* (1992) 111 FLR 332 (FamCAFC); *In Marriage of Smith* (1991) 102 FLR 359 (FamCAFC).

2 *In Marriage of Waters* (1981) 6 Fam LR 871 (FamCAFC), 875 (the Court).

3 *In Marriage of Bell* (1992) 111 FLR 332 (FamCAFC), 346–347 (the Court).

4 *In Marriage of Little* (1990) 100 FLR 322 (FamCAFC), 326 (the Court, citing the trial judge).

5 *In Marriage of Little* (1990) 100 FLR 322 (FamCAFC), 326 (the Court, citing the trial judge).

6 *In Marriage of Little* (1990) 100 FLR 322 (FamCAFC), 329 (the Court).

[17.15.182] The potential problem of a trial judge assigning fixed sums to property was highlighted in *In Marriage of Joshua* (1997) 22 Fam LR 203. In this case both parties to the dispute agreed that the value of the largest asset (strata title units in Morley, Western Australia) was valued at $880,000. The trial judge then made an allowance for realisation costs (which were estimated at $28,000), capital gains tax ($75,000) and the mortgage debt ($242,000), which left a net value of $535,000. In his judgment of 30 October 1995, the trial judge came to the conclusion that this property could be transferred to the wife on the basis that she pay the husband $72,450 for the transfer, as part of the settlement and allocation of all assets.[1] As at 1 July 1997, the wife was finally able to sell the property for $650,000, some $230,000 less than the agreed value at trial. The capital gains tax that would have been payable at $880,000 was now not applicable, and so the difference between the anticipated net sale proceeds and actual net proceeds amounted to $155,000.

The wife appealed to the Full Court of the Family Court for an extension of time to appeal against the orders made by the trial judge. If the extension was allowed, the appeal against the trial judge's order would be based on a number of arguments, including that the judge's orders "left the wife hostage to the vagaries of the real estate market"[2] and were unjust.

The Full Court dismissed the appeal for an extension of time to appeal for a number of reasons and in so doing distinguished *In Marriage of Waters* (1981) 6 Fam LR 871, *In Marriage of Docters Van Leeuwen* (1990) 100 FLR 261, and *In Marriage of Bell* (1992) 111 FLR 332[3] as follows:

(1) the property in question was not the only significant property held by the two parties (there were two other properties, one worth $376,500 and the other $215,000), and the trial judge did not order the sale of the property which differentiated it from *In Marriage of Waters* and *In Marriage of Docters Van Leeuwen*; and

(2) the trial judge did not order the sale of the Morley property in the event that the wife did not pay the husband his fixed entitlement within a reasonable time which distinguished it from *In Marriage of Bell* and it was impossible for the Court of Appeal to see this failure as an error at law when neither party asked the trial judge to do so.

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1 *In Marriage of Joshua* (1997) 22 Fam LR 203 (FamCA), 206 (Lindenmayer J, citing the trial judge).

2 *In Marriage of Joshua* (1997) 22 Fam LR 203 (FamCA), 210 (Lindenmayer J).

3 *In Marriage of Waters* (1981) 6 Fam LR 871 (FamCAFC); *In Marriage of Docters Van Leeuwen* (1990) 100 FLR 261 (FamCAFC); *In Marriage of Bell* (1992) 111 FLR 332 (FamCA).

Commercial Property

General

[17.15.183] Commercial properties should generally be valued by capitalising their income (see [17.15.168]) or discounting their cash flow: see [17.15.169]. Other methods may be appropriate in particular circumstances. such as where "highest and best use" would be for the property to be redevoloped.

[17.15.184] Many commercial property valuers prefer to rely on comparable sales (see [17.15.167]) as the primary, and often the only, determinant of a formal property valuation in preference to more formalised discounted cash flow type valuations: see [17.15.169]. While in theory it is clearly correct to look at actual market evidence, the reality of most commercial and industrial property valuations is that truly comparable sales are not common. They occur relatively infrequently and there are often significant differences between properties in terms of factors such as rent and lease terms, their relative relationship to other actual market rents, comparative security of income, tenant quality, rent review frequency and terms, taxation shelter and growth prospects.

By way of comparison, parcels of (minority) shares in listed companies are traded daily on the stock exchange providing constant contemporaneous evidence of exchange values of homogeneous assets. Property transactions, particularly at the higher value end of the range, occur much less frequently and exchange values are more likely to reflect particular, and often not readily observable, circumstances unique to the transaction.

If, as is often the case, there are no contemporaneous comparable property sales, then a valuer has to look at sales in other locations and in other time periods and try and adjust those values for the differences and for general market trends in the meantime. In periods of rapidly changing economic conditions, a time gap of even just a few months can have a material impact on the value of a property based on what appears to be a comparable sale.

Simply put, few sales of industrial properties or commercial buildings are truly comparable in their characteristics (the full details of which are rarely publicly known) let alone contemporaneous.

In *Grieves v Grieves* (2012) 49 Fam LR 442; [2012] FamCA 691 the selection of comparable sales by the parties' valuers was a key issue. One valuer relied on comparable sales of income producing residential unit blocks whilst the other valuer had regard to sales of properties for commercial redevelopment. Ultimately the issue was resolved by the Court determining that the highest and best use of the property was its continuing use and the adoption of a capitalisation of earnings basis of valuation.[1]

Moreover, as noted in *In Marriage of Smith* (1991) 102 FLR 359, offers to purchase or sell cannot be used as a substitute for comparable sales evidence to determine the value of a property (where there is a lack of comparable sales), based on a long line of authority.[2]

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1 *Grieves v Grieves* (2012) 49 Fam LR 442; [2012] FamCA 691, [26], [56] (Coleman J).

2 *In Marriage of Smith* (1991) 102 FLR 359 (FamCAFC), 362 (the Court). See *McDonald v Deputy Commissioner of Land Tax (NSW)* (1915) 20 CLR 231; *James Patrick & Co Pty Ltd v Minister of State for the Navy* [1944] ALR 354 (HCA); *Gregory v Federal Commissioner of Taxation* (1971) 123 CLR 547; 45 ALJR 136.

Role of Expert Valuer

[17.15.185] Similar to residential property and other valuations (see [17.15.174]–[17.15.180]), an expert valuer will play a significant role in the court's determination of the value of commercial property. Whilst the opinions of the valuer(s) do not have to be accepted by the court, the expert valuer provides the court with a basis for determining value.

In *Grieves v Grieves* (2012) 49 Fam LR 442; [2012] FamCA 691 despite a significant difference between the two expert valuers, the court assessed a value for the property in question after counsel for the parties conceded that the court could properly do so. If unable to accept either yield rate used by the valuers, consider a different rate, not simply by "splitting the difference" but by determining an intermediate figure which would reflect a more appropriate yield.

In this case the court adopted the midpoint of the yield rates adopted by the valuers to reflect the difference between the commercial focus adopted by one valuer and the residential focus adopted by the other. The court concluded that the mid-point appropriately reflected that 50% of the income from the property was from residential tenants and 50% of the income was from commercial tenants.[1]

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1 *Grieves v Grieves* (2012) 49 Fam LR 442; [2012] FamCA 691, [53], [55] (Coleman J).

Different Valuations of Same Property

[17.15.186] The approach adopted by the Family Court in relation to differing valuation is the same regardless of the type of property being valued. That approach, in the context of residential property valuations, is set out at [17.15.175]–[17.15.180], and the same principles apply to commercial property.

[17.15.187] Case law is often concerned with disputes over valuation of property. Case law is also concerned with how the judge has assessed each valuation to arrive at an amount which he or she considers to be appropriate.

In *In Marriage of MacGregor* (1996) 21 Fam LR 57, one of the major disputes was in relation to the valuation of a commercial property. The facts of the case (in relation to property valuation) were that a commercial property was valued by the wife's valuer at $2,900,000 and at $2,600,000 by the husband's valuer. Both valuers made an allowance for structural inadequacies, the wife's valuer discounting the property by $200,000 and the husband's valuer by $300,000. The wife's valuer had based his assessment of deficiencies on an engineer's report, and the husband's valuer had relied on this report plus included his own assessment of other deficiencies (where no engineer's advice had been sought).

Both valuers used the capitalisation of income method (see [17.15.168]) to determine the value of the property. The valuers differed in the capitalisation rate used, with the wife's valuer using a rate of 12% (before adjusting for structural defects), and the husband's valuer using 11.9%. The trial judge pointed out "the margin is a narrow one although it translated into quite a substantial difference when applied to the annual rental".[1]

The trial judge found the value to be $2,900,000 based on the wife's valuer's report. The judge favoured the yield used by the wife's valuer in that it was based on more comparable properties than those used by the valuer appointed by the husband. The assessment of structural deficiencies was found to be valued at $200,000 based on the engineer's report, as the judge only considered evidence in this respect from a properly qualified person. The judge considered the assessment of structural deficiencies outside the area of expertise of the husband's valuer.

The husband appealed against the trial judge's use of the wife's valuer's capitalisation rate and his assessment of structural deficiencies. The appeal was dismissed on the basis that the issues were questions of fact, and there was no reason given not to accept the trial judge's decision.

In *In Marriage of Street* (unreported, FamCAFC, 1840 of 1991, 18 August 1993), the main issue was the valuation of two rural properties referred to as "Sussex" and "Carrawatha". The wife's valuer, Mr Hopcraft, valued the two properties at $865,000. In contrast, the husband's valuer, Mr Collins, ascribed a value of $610,000 to the properties.

The trial judge preferred the valuation by Mr Hopcraft, citing the following reasons:

(1) the greater experience of Mr Hopcraft in valuing properties in the district of the properties in question;

(2) the superior methodology employed by Mr Hopcraft in his valuation;

(3) the valuation by Mr Hopcraft of the two properties as two discrete properties, rather than Mr Collins' valuation of the properties together; and

(4) the superior methodology employed by Mr Hopcraft in valuing the improvements on rural land.[2]

The trial judge found that Mr Collins' methodology produced an unrealistic result and therefore his valuation was fundamentally flawed (no challenge was made to this finding on appeal).[3]

The husband appealed, claiming that the trial judge had erred in preferring the evidence of Mr Hopcraft over that of Mr Collins, including:

(1) the trial judge should not have had regard to the values ascribed by the husband to the properties in loan application forms; and

(2) the trial judge did not have regard to comparable sales in the area.[4]

Upon appeal, reference was made to a loan application made by the husband, dated 11 December 1991, wherein he ascribed a value of $880,000 to the properties. Similarly, in a subsequent loan application dated 2 January 1992, the husband had valued the properties at $700,000. Both these events occurred after the date of separation, and more importantly, after the commencement of the hearing.

The Appeal Court found that the above evidence played little part in the trial judge's acceptance of Mr Hopcraft's evidence. The trial judge did not use the above evidence to value the properties in question, rather it merely indicated to the trial judge that the husband apparently did not believe the valuation of his valuer.

Regarding the issue of comparable sales, it was found on appeal that the trial judge had made proper consideration of the comparable sales, in that there had been discussion and reasons provided by Mr Hopcraft in his rejection of the sales as comparable sales for the purposes of the valuation of the two properties in question. Further, Mr Hopcraft's valuation was not seen to be unreliable from this point of view, or one that could not be relied upon by the trial judge in the valuation of the relevant properties.

The case of *In Marriage of Ferraro* (1992) 111 FLR 124[5] also raised the issue of a valuation which was provided to a bank around the time of the trial that was significantly higher than the valuation given at the trial. The husband's valuer in this case had valued certain property for a bank at 20%–25% higher in July 1991 than in his valuation used for the Court in October 1991. The valuer's reasons for the significant drop over such a short period (which were adopted by the trial judge) were that there was a continuing decline in demand, evidence of later comparable sales, and that yields had continued to rise (ie, values had continued to fall).

There were a number of substantial industrial properties whose values were in dispute. In each case, the wife's valuer adopted lower capitalisation rates and thus reached higher values for the property, and the husband's valuer adopted higher capitalisation rates and thus lower values. As the properties were worth several million dollars, the difference was significant. The trial judge accepted the evidence of the husband's valuer, as the trial judge found him to be more credible and reliable than the wife's valuer. This was upheld on appeal.

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1 *In Marriage of MacGregor* (1996) 21 Fam LR 57 (FamCAFC), 67 (the Court).
2 *In Marriage of Street* (unreported, FamCAFC, 1840 of 1991, 18 August 1993), 11 (the Court).
3 *In Marriage of Street* (unreported, FamCAFC, 1840 of 1991, 18 August 1993), 12 (the Court).
4 *In Marriage of Street* (unreported, FamCAFC, 1840 of 1991, 18 August 1993), 10 (the Court).
5 *In Marriage of Ferraro* (1992) 111 FLR 124 (FamCAFC).

Highest and Best Use

[17.15.188] The anticipated cash flows from the use of property should not be confined to the present use of the property, but instead should be based on "highest and best use" (see [17.15.164]) of the property: see [17.15.171]. In *Brown v Brown* (unreported, FamCAFC, 5896 of 1991, 27 July 1993), the issue being contested was the competing valuation methodologies of the wife and husband's appointed valuers of the grazing property "Minora".

The wife's valuer, Mr Hopcraft, developed two valuations, the first being on the basis of the property as a going concern (continuance of sheep-grazing activity on the property) deriving a value for the property of $610,000. The second basis of valuation developed consisted of the property being subdivided and sold as hobby farms, deriving a value of $860,000.

The husband's valuer, Mr Grigson, developed his valuation on the basis of a going concern as a grazing property, and used public information pertaining to dry sheep equivalent figures in his valuation of the property (due to the lack of comparable sales data) to arrive at a value of $469,898.

The trial judge had found that:

> [T]he only realistic use of the property at the present time was its continued use as a sheep-grazing property, and came to the conclusion that the valuation of Mr Grigson was to be preferred.[1]

This is because Mr Hopcraft could not prove that the relevant authorities would approve of the subdivision, or that there were interested parties willing to purchase the land or even whether it was economically viable to pursue such a course of action.

The wife appealed on the basis that the trial judge did not evaluate the valuation of Mr Hopcraft, which was prepared assuming the property was a going concern as grazing property, that figure being $610,000, as compared to the valuation of Mr Grigson's assessment at $498,898.

The Appeal Court found that the methodology employed by Mr Hopcraft in arriving at his valuation of $610,000 for the property was based on four comparable sales of property in the Rylstone area in 1992, whilst ignoring the dry sheep equivalent method used by Mr Grigson.

It was contended that Mr Hopcraft failed to tie the valuation to the comparable sales he quoted, thus giving little explanation as to how his valuation was arrived at. It was found by the Full Court that the trial judge had considered the two competing valuations in his decision. In adopting Mr Grigson's valuation, His Honour relied on Mr Grigson's relative experience as a valuer. Mr Hopcraft gave little evidence of his valuation methodology, undermining the credibility of his valuation.[2]

It was held that although the trial judge's approach was inelegant, it is clear that the trial judge had committed no demonstrable error in his evaluation of the different valuations for the "Minora" property.[3] The appeal was dismissed.

In *Bania v Jacopo (No 2)* [2011] FamCAFC 139 the Full Court considered the application of the highest and best use principle and referred to *GWR v VAR* (2006) 36 Fam LR 237; [2006] FamCA 894 in which the Full Court said:[4]

> The principle of "highest and best use" finds repeated expression throughout the authorities relevant to the valuation of real property ... the principle was succinctly stated [by Pullin J in *Flotilla Nominees Pty Ltd v Land Authority (WA)* (2003) 27 WAR 403; 129 LGERA 65; [2003] WASC 122]:
>
> ...
>
> Regard must be had to every element of value which the lands possess. Every such element must be taken into consideration in so far as they increase the value to the owner of the land. ... In short regard

> should be had to the highest and best use of the subject land, meaning the most advantageous use of the subject and having regard to planning and all other relevant factors affecting its present and future potential.[5]

In *Bania v Jacopo*, the valuer for the wife made direct reference to this principle when assessing the value of two adjacent lots at $150,000 which together could be used to build a dwelling. The value of the individual lots was much less, totalling $45,000 as their use was limited.

The Full Court held that highest and best use was the preferred basis of valuation and that attribution of the value of the whole of the land solely to the husband's efforts in purchasing the second block was not open to the trial judge based upon the evidence.[6]

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1 *Brown v Brown* (unreported, FamCAFC, 5896 of 1991, 27 July 1993), 13 (Baker J).
2 *Brown v Brown* (unreported, FamCAFC, 5896 of 1991, 27 July 1993), 23 (Baker J).
3 *Brown v Brown* (unreported, FamCAFC, 5896 of 1991, 27 July 1993), 27 (Baker J).
4 *Bania v Jacopo (No 2)* [2011] FamCAFC 139, [40] (Ainslie-Wallace J).
5 *Flotilla Nominees Pty Ltd v Land Authority (WA)* (2003) 27 WAR 403; 129 LGERA 65; [2003] WASC 122, [19] (Pullin J).
6 *Bania v Jacopo (No 2)* [2011] FamCAFC 139, [46] (Ainslie-Wallace J).

Allowance for Risk and Profit

[17.15.189] The allowance for risk and profit is for the uncertainty regarding the amount of time it takes to gain development and building approvals, demolish existing buildings and build any new constructions, and for the risks involved. In the case of *Brown v Brown* (unreported, FamCAFC, 5896 of 1991, 27 July 1993), the valuation prepared for the wife for the hobby farm subdivision ignored an allowance for risk and profit which could have been incorporated into the valuation performed for the wife to decrease the value of the land, on the assumption that the land could be subdivided and sold for hobby farms.

The case of *In Marriage of Davies* (1995) 129 FLR 1, did, however, incorporate this notion of a profit/risk allowance, but the determination of the value of the profit/risk allowance was not in dispute, and hence not discussed in any great detail. In that case, the former matrimonial home was situated on rural land in Mt Helena. The husband's valuer, Mr Barnao, valued the entire property at $660,000 (before selling costs of $11,000, but after $30,000 in subdivision costs), on the basis that the existing property could be subdivided into three lots. The valuer then made an allowance of $43,000 for "profit and risk"[1] and $20,000 for development costs being fees, holding costs, survey charges and other costs. He then made the assessment that two of the blocks would be worth $196,000 in total, and the remaining larger block $390,000, giving a total value of $586,000. He then reduced the total price by $16,000 (a "market factor reduction") on the basis that "there was limited evidence to confirm that a purchaser would be prepared to pay such a price"[2] to give a net value of $570,000.

Another interesting adjustment made in this case, but not examined in detail in the judgment, is the notion that price should be adjusted for a "market factor". The trial judge, whilst amending the quantum, agreed with the principle. This adjustment in fact should be incorporated in the original determination of value, rather than adjusted on a percentage basis after a "notional" value has been determined, which makes this adjustment quite unusual.[3]

1 *In Marriage of Davies* (1995) 129 FLR 1 (FamCAFC), 13, 19 (the Court).
2 *In Marriage of Davies* (1995) 129 FLR 1 (FamCAFC), 13 (the Court).
3 *In Marriage of Davies* (1995) 129 FLR 1 (FamCAFC), 13 (the Court).

Valuation of Options to Purchase Property

[17.15.190] The court's determination of the value of an option to purchase property has not been widely tested in the Family Court. In *In Marriage of Rickaby* (1995) 127 FLR 1, however, the Court found that an option to purchase property does constitute an equitable interest,[1] and thus falls under the definition of property for the purposes of the *Family Law Act 1975* (Cth).

The relevant facts of this case were that the wife was given an option to purchase a house that had been owned by her father, per her father's will. The house had an agreed value of $145,000 and the option was that the wife could purchase the house for $35,000, with this money to be paid into the residual pool of assets, of which the wife was entitled to one-quarter as a beneficiary. Counsel for the wife argued that the option to purchase was not itself property of the wife as defined in s 4(1) of the Act, and it therefore was not property of the parties to the marriage, and thus should not be regarded as part of the pool of assets available for division between the parties.[2] This was a key issue of the case.

The subsequent issue that arose if the option was determined to be property was the value of that option.

Lindenmayer J found that the option did constitute an equitable interest in the property,[3] on the basis of a number of supporting decisions.[4]

The value of the option then had to be determined. The trial judge stated:

> *Prima facie* the value of the wife's option is the difference between the market value of the property at the time she exercises her option and the option price which she must thereupon pay for it.[5]

This would make the option worth $110,000 ($145,000 less $35,000).

However, the judge went on to make some adjustments to the value of the option. As the wife did not have $35,000 to pay for the property, the judge allowed for the costs of borrowing money to purchase the property, and also the cost of selling the property and transferring it to a purchaser. However, after allowing for the wife's one-quarter interest in the purchase price of $35,000, there was no net adjustment made to the $110,000.

The judge then discounted the figure further for contingencies, which included the fact that she was unable to sell the property for 12 months because her children had the right (per the will) to occupy the property for 12 months. The judge also noted that there may have been other unforeseen events which would impact on the eventual sales price of the property.[6] The judge applied a discount rate of 10% for contingencies, thus reducing the figure to $100,000.

In this case, no allowance was made for the possibility that the value of the house could increase between the date of the judgment and the ultimate sale date, which would increase the value of the option, whereas an allowance had been made by the judge in case the sale price had fallen in that period, which reduced its value.

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1 *In Marriage of Rickaby* (1995) 127 FLR 1 (FamCA), 14 (Lindenmayer J).
2 *In Marriage of Rickaby* (1995) 127 FLR 1 (FamCA), 8 (Lindenmayer J).
3 *In Marriage of Rickaby* (1995) 127 FLR 1 (FamCA), 14 (Lindenmayer J).
4 *O'Neill v O'Connell* (1946) 72 CLR 101 adopted; *Oliver v Oliver* (1958) 99 CLR 20; 32 ALJR 198; *Re Lander (decd)* [1951] 1 Ch 546; *Re Busby; Busby v Busby* (1930) 30 SR (NSW) 399; *Skelton v Younghouse* [1942] AC 571. Lindenmayer J also referred to LC Voumard, *Law Relating to the Sale of Land in Victoria* (The Law Book Company Limited, 3rd ed, 1978) 10, which refers to the aforementioned cases and states "[w]hatever may be the form of the option, it confers on the beneficiary an immediate contingent equitable interest in the land".
5 *In Marriage of Rickaby* (1995) 127 FLR 1 (FamCA), 14 (Lindenmayer J).
6 *In Marriage of Rickaby* (1995) 127 FLR 1 (FamCA), 14–15 (Lindenmayer J).

[The next text page is 701]

Valuation of Trusts

Overview

[17.15.247] A trust is an obligation which rests on a person, called the trustee, to deal with property for the benefit of a person, called the beneficiary. Thus, for a trust to exist there must be a trustee, trust property and a beneficiary or, beneficiaries, in respect of which the law recognises a trust obligation. The trustee generally carries the burdens of ownership of the trust property subject to a right of indemnity out of the trust property in respect of liabilities properly incurred by the trustee in the administration of the trust property. Any beneficiaries are entitled to the benefit of the trust property.

[17.15.248] The most common types of trusts encountered in family law cases are discretionary trusts and fixed trusts, the latter generally in the form of unit trusts. Discretionary trusts are trusts where a beneficiary's entitlement to income, or the capital of the trust, or both, is at the discretion of the trustee, with the beneficiary being chosen from a nominated class of beneficiaries. Where the interest of a beneficiary in the trust property is not dependent upon the exercise of the trustee's discretion and is fixed by the instrument creating the trust itself the trust is called a fixed trust. A single trust instrument may contain elements of both discretionary trusts and fixed trusts.

[17.15.249] A unit trust is a form of fixed trust which is common in business. In the case of a unit trust, trust property is held for the benefit of certain persons, called unitholders. The rights of the unitholders are fixed by the instrument creating the trust and the units are generally transferable and, in the case of an unlisted unit trust, may be redeemable. The transfer of units in an unlisted unit trust is generally subject to restrictions on transfer similar to those which apply in the case of many private companies.

A unit in a unit trust is property for family law purposes. From a valuation perspective, valuing a unit in a unit trust is similar in many respects to valuing a share in a company. The major differentiating point in the case of a unit trust is that the trust deed usually requires that the whole of the trust's income be distributed each year. This is in contrast to companies which generally do not distribute as dividends each year the whole of their income.

By contrast, the interest of a beneficiary under a discretionary trust which is dependant upon the trustee of the trust exercising its discretion in the beneficiary's favour, represents a mere hope or expectancy, or "a right to be considered as a potential recipient of benefit by the trustees",[1] which does not constitute property for the purposes of the *Family Law Act 1975* (Cth). However, trust assets may be treated as the property of a spouse in certain circumstances. Trust assets may also be treated as a financial resource of a spouse or a factor to be taken into account under s 75(2)(o) of the Act.

As a consequence, while a valuer may be called upon to value units held by a spouse in a unit trust, what is valued in the case of a discretionary trust is generally the value of the trust as a whole.

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1 *Kennon v Spry* (2008) 238 CLR 366; 83 ALJR 145; 1 ASTLR 271; [2008] HCA 56, [74] (French CJ) citing *Gartside v Inland Revenue Commissioners* [1968] AC 553, 617 (Lord Wilberforce).

Valuation of Trust and Units in Unit Trust

General

[17.15.251] There are three main differences between a company and a trust which must be taken into account in valuing trusts and interests in trusts. These differences are that:

(1) the trustee of a trust, in its capacity as such, does not generally pay tax; and

(2) the annual income of a trust is generally distributed to beneficiaries to avoid the trustee paying tax; and

(3) a discretionary beneficiary may or may not receive a distribution.

The reason for these differences stems from the trustee's ability to alter who receives the distribution from the trust and the way in which the taxable income of a trust is subjected to tax: see [17.15.252]–[17.15.256].

Taxation of Trusts and Interests in Trusts

[17.15.252] The trust deed of a trust will generally require the trustee to calculate the accounting income of the trust each year in the manner prescribed in the trust deed. The trust deed may or may not define how income is to be calculated for those purposes.

[17.15.253] A trust is not a taxpayer for tax purposes. Instead, where the beneficiaries are entitled to all of the accounting income of the trust, its taxable income is taxed in their hands. Although the trustee of a trust in its capacity as such is not required to pay tax, the trustee is required to calculate the taxable income of the trust and lodge an income tax return as if it was a taxpayer. The taxable income of the trust may differ from the accounting income of the trust for a number of reasons, such as expenses charged that are not deductible for tax, or due to different depreciation rates for accounting and tax purposes.

In broad terms each beneficiary is required to include in his/her taxable income a share of the taxable income of the trust based on his/her proportionate entitlement to the accounting income of the trust. For example, if the accounting income of the trust is $100, its taxable income $90 and the trustee exercises its discretion to distribute $50 to A and $50 to B, then A and B will each include $45 in taxable income.[1]

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1 In the event that the trust is a discretionary trust, the additional $5 distributed to A and B is not subject to tax. If the distribution is made in respect of units in a unit trust, the additional $5 will, other than in limited circumstances, reduce the cost of the units in calculating any capital gain on their disposal.

[17.15.254] Taxable income that is not distributed to the beneficiaries of the trust before the end of each financial year is taxed at the highest marginal tax rate applicable to individuals, plus the medicare levy. The subsequent distribution to beneficiaries of that previously undistributed income should not be subject to tax in the hands of the beneficiaries. It should also be noted that as a trust can only distribute trust law income, unless the trust deed defines trust law income as "net income" under s 95(1) of the *Income Tax Assessment Act 1936* (Cth), where an accounting loss occurs in a trust which has taxable income, any taxable income will be assessed to the trustee.

[17.15.255] In order to avoid the trustee paying tax at the top personal tax rate it is usual for all of the accounting income of trusts to be distributed annually to beneficiaries. In the case of unit trusts, the trust deed generally provides that unitholders are entitled to their proportionate share of the trust's annual accounting income. In the case of discretionary trusts, the trustee will generally exercise its discretion to distribute the whole of the accounting income to beneficiaries each year. Many discretionary trust deeds contain default provisions which determine entitlement to trust income in the event that the trustee fails to exercise his discretion before year end.

[17.15.256] Tax losses arising in a trust are similar to tax losses in companies. They are not available for distribution to trust beneficiaries or unitholders and can only be carried forward for offset against other taxable income earned by the trust, subject to the satisfaction of certain tests.[1]

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1 RL Deutsch et al, *Australian Tax Handbook 2017* (Thomson Reuters, 2017), [23.800]–[23.1270].

Methods of Valuing

[17.15.257] The basic principles that apply to the valuation of a company also apply to the valuation of a trust, whether a fixed or a discretionary trust: see [17.15.65]. However, as the trustee of the trust does not generally pay tax on the taxable income of the trust, for valuation purposes the trust is treated as paying tax equal to the prevailing corporate tax rate. The value of a business conducted by an entity, or a proprietor's interest in the underlying business, should not materially alter because of the point at which income tax is assessed. In valuing interests in many entities it is common practice to apply a notional tax rate. This is because, whether a business is conducted through a company or a trust, it should have no material effect on the value of the equity in the underlying business. Clearly, if this were not the case, many more businesses would be conducted through trust structures. Accordingly, for valuation purposes, income tax is recognised on a notional basis based on the prevailing corporate tax rate, as a notional deduction from profits. The mathematics are applied, the valuation result is the same, as demonstrated by the table below.

Table 10.1 Reconciliation of Post-Tax and Pre-Tax Multiples

Pre-tax profits	100	100
Less notional tax at 30%	*30*	-
– After tax earnings	70	100
Value based on after-tax earnings multiple of	10x	-
Value based on pre-tax earnings multiple of	-	*7x*
Value of entity	*700*	*700*

As a further demonstration of the principle that the value of a proprietor's interest in an underlying business should not materially alter because of the point at which income tax is assessed – the value of a $1,000 government bond does not have a different market value depending on whether it is owned by a company (subject to company income tax) or a tax free entity.

[17.15.258] Where unitholders' loan accounts are treated as liabilities in the balance sheet, these accounts may represent, in reality, the capital employed by the unitholders in the business carried on via the trust, and it is appropriate to treat such loan accounts as equity. In valuing a controlling interest in a trust on the basis of earnings, it is necessary to add back any interest paid or payable on these loan accounts to the profit in order to arrive at the estimated future maintainable profits as if the trust were a company: see [17.15.75]. Where loan accounts are not owing in the same ratio that units are held, and the units are not being valued as a whole, it may be necessary to notionally capitalise the trust on the basis of a sustainable debt/equity ratio and treat the loan accounts as a deduction from this value.

Methods of Valuing Units in Trust

General

[17.15.259] The basic principles that apply to the valuation of shares in a company (see [17.15.109]–[17.15.144]) also apply to the valuation of units in a unit trust. As with shares in a company, the value of units in an unlisted unit trust will be dependent upon the relative size of the interest being valued.

Controlling Interests

[17.15.260] A controlling interest in an unlisted unit trust will usually be valued on the basis of its pro rata interest in the value of the trust as a whole. Although it will depend on the circumstances, there is often little disadvantage in holding a controlling, but not 100%, interest in a unit trust to holding a 100% interest. This is because trusts normally distribute all their income each year.

Non-controlling Interests

[17.15.261] A non-controlling interest in an unlisted unit trust will generally be valued either on the basis of its adjusted net asset value or by capitalising future maintainable distributions. In the latter case, the level of future maintainable distributions for a minority holding in a unit trust is normally much higher than for a corresponding percentage equity holding in a company. This is because unit trusts generally distribute the whole of the accounting income each year to unitholders: see [17.15.255]. The value so determined would need to be reduced by a discount to reflect the fact that there is no ready market for the units.

[17.15.262] Where the unit trust is an investment trust, it may be preferable to value a non-controlling unitholding in the trust based on its proportionate share of the net assets of the unit trust, reduced by both a minority interest discount (see [17.15.263]) and a non-negotiability discount (noting that the minority interest discount may be small): see [17.15.264]. The reason this method may be preferable to the capitalisation of future maintainable distributions methodology is that the value of the underlying assets of the trust is observable and less susceptible to valuation error than the capitalisation of future maintainable distribution methodology. The value of those assets should reflect their future earnings potential.

Minority Interest Discount

[17.15.263] The level of discount to be applied to a minority interest in a non-listed trust will generally be significantly less than that which would apply in the case of a company. This is because a trust traditionally distributes all of its accounting income (see [17.15.255]) so that the inability to control the distribution of cash and access the minority unit holders pro rata share of the underlying cash flow is very much less of an issue. In addition, where the trust is an investment trust which derives passive income, eg rent, dividends and interest, the inability to control the strategic direction of the trust and the investment risks is not generally an issue. This is in contrast to the case of an entity carrying on an active trading business.

Non-negotiability Discount

[17.15.264] Any discount for the lack of negotiability of a minority interest in an unlisted unit trust should have regard to the same factors as applicable to shares in an unlisted company, including the impact of any pre-emptive provisions contained in the trust deed: see [17.15.123]. The level of non-negotiability discount, and indeed the fair value of the units in the trust, should also take into account any redemption provisions contained in the trust deed.

Valuation Approach Accepted by Family Court

[17.15.265] The Family Court has accepted the application of a discount when valuing a minority unitholding in a unit trust but without distinguishing between a minority interest (see [17.15.263]) and non-negotiability (see [17.15.264]) component. In *In Marriage of Goodwin* (1990) 101 FLR 386 the Full Court of the Family Court was required to determine the value of a husband's 25% interest in a property unit trust in which the remaining 75% was owned by two business associates. The trial judge valued the husband's interest based on his pro rata entitlement to the value of the trust as a whole and went on to consider whether a discount should be applied and if so, the level of that discount. The trust deed provided a procedure for the transfer of units requiring the vendor to advise the trustee of the price at which he wished to sell and, if the trustee disagreed, to sell at the "fair price" determined by the auditor. Under the trust deed a unit holder could also require the trustee to redeem units based on the proportionate share of the value of the trust and prescribed a method of arriving at this value. The trial judge accepted evidence of the husband's valuer that there would be practical difficulties in redeeming or selling his units because:

(1) if the unitholder insisted upon a redemption and it was not convenient for the other unitholders to let him cash it in, they could make it difficult for him to do so;

(2) an investor would be unlikely to take over a personal guarantee for $13 million owing by the trustee and still pay the same price as would an acquirer of a 25% interest in the trust; and

(3) trust units could not be used as readily as a security as real property.

The Full Court accepted that there were serious practical difficulties with redeeming units, particularly in relation to the valuation of the units which, if the other parties chose to create difficulties, would involve time consuming and costly disputation. The court also considered that the other matters referred to by the trial judge were relevant as factors diminishing the price. In the absence of specific evidence directed to an appropriate discount factor the Full Court found that it was open to the trial judge to apply the 50% discount adopted by the husband's valuer.

Accrued Income Entitlement

[17.15.266] The accrued income entitlement of units may have a significant impact on the value of the units. Where units in a trust are being valued prior to a distribution date, their value should take into account income accrued from the start of the year to the date of valuation. This impact is further complicated by tax considerations. To the extent that the value of the accrued income is reflected in the value of the units, it will generally be capital for income tax purposes to both the buyer and seller of the units. However, the distribution, when it is made, will generally be taxable income in the hands of the recipient.

At a practical level, in a negotiated transaction, this problem may be overcome by having an interim distribution of trust income. More commonly, accrued income entitlements are assessed on the basis of budgeted results, supported or adjusted by the actual result reflected in monthly management accounts, and adjusted for a notional income tax charge at standard company rates.

This basis is predicated on a number of assumptions and may be modified depending on the facts of the particular valuation. The assumptions are:

(1) the whole of the income of the trust will be distributed (account must be taken of differences between accounting and taxable income);

(2) the transfer of the units will be registered before the distribution date;

(3) the income will be fully taxable in the hands of the recipient;

(4) the income will be distributed in cash;

(5) the proportion of accrued income included in the units' value will be a capital sum not assessable to the vendor if CGT applies and not deductible to the purchaser until the units are resold;

(6) capital gains tax liabilities, after allowing for indexation, are already reflected in the capitalisation rate; and

(7) the time cost of money outlaid by the purchaser in paying for the accrued income entitlement will be compensated for by the trust distribution being received on a pre-tax basis.

It should be noted, however, that having determined the present value of the future cash flows (that the interest in the trust will generate), the capitalisation rate may have already reflected an element of accrued income entitlement. Accordingly, the apparent level of precision implied by the factors referred to in [17.15.265] may not be justified in practice.

Beneficiary Loan Accounts

[17.15.267] Where one or both of the parties have borrowed from/lent to a trust, the loan accounts should be reflected in the assets/liabilities of the trust. The party's corresponding liability/asset should also be reflected in their net asset pool to avoid double counting of the asset on settlement. In *Giacomel v Giacomel* (unreported, FamCAFC, 232 of 1979, 22 April 1994), debts owed to the husband by the family company and trust were included as a liability of the parties but omitted from the assets of the husband. The Full Court held that:

> [I]t is common ground that the pool of assets owned by the parties had been understated … all of which is money owed to the husband from a family company and a trust and therefore, it is appropriate to add to the pool of assets for division the additional sum.[1]

In addition, in the case of *In Marriage of Costa* (unreported, FamCAFC, 2259 of 1994, 8 August 1996) it was held that:

> [T]he trial judge included the value of the Costa Family Trust in the assets of the parties. However, the accountants, in arriving at the relevant figures, included as assets of the trust monies owed by the parties. In failing to include those amounts owing as liabilities of the parties, his Honour overvalued their total net assets.[2]

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1 *Giacomel v Giacomel* (unreported, FamCAFC, 232 of 1979, 22 April 1994), 15 (Kay J).
2 *In Marriage of Costa* (unreported, FamCAFC, 2259 of 1994, 8 August 1996), 29 (the Court).

Treatment of Discretionary Trusts in Family Court

Background

[17.15.268] Where a matrimonial dispute involves a discretionary trust that is used as a vehicle for conducting the business or investment activities of a family, then the laws of trusts and companies gives way in the Family Court to reality, fairness and equity in layperson's terms. [1] In matrimonial matters the Family Court has adopted the principle that regard be had to the realities of the situation rather than their legalities. The distinction between the substance of financial arrangements concerning companies and trust and their form depends upon the factual circumstances of each case.

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1 PK Cooper (ed), *Trusts in Action* (Blackstone Press, 1995).

[17.15.269] Property, for the purposes of the *Family Law Act 1975* (Cth), does not include a mere hope or expectancy[1] and therefore does not include the interest of a beneficiary under a discretionary trust. The interest of a beneficiary under a discretionary trust has been described as a hope, or at most no more than an expectation, that the trustee will exercise his or her discretion in the beneficiary's favour when deciding upon the distribution of income or vesting of trust property.[2]

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1 *In Marriage of W* (1980) 6 Fam LR 538 (FamCA), 543 (Nygh J).
2 See Anthony Dickey, *Family Law* (Thomson Reuters, 6th ed, 2014) [37.110].

[17.15.270] The court recognises circumstances which enable it to bring trust assets within its reach, notwithstanding that they are owned by a third party. In *Ascot Investments Pty Ltd v Harper* (1981) 148 CLR 337; 55 ALJR 233, after finding that the Family Court has no power to make orders requiring third parties to do what they are not legally bound to do, Gibbs J went on to add that:

> The position is, I think, different if the alleged rights powers or privileges of the third party are only a sham and have been brought into being, in appearance rather than reality, as a device to assist one party to evade his or her obligations under the Act. Sham transactions may always be disregarded. Similarly, if a company is completely controlled by one party to a marriage, so that in reality an order against the company is an order against the party, the fact that in form the order appears to affect the rights of the company may not necessarily invalidate it.
>
> Except in the case of shams, and companies that are mere puppets of a party to the marriage, the Family Court must take the property of a party to the marriage as it finds it. The Family Court cannot ignore the interests of third parties in the property, nor the existence of conditions or covenants that limit the rights of the party who owns it.[1]

The comments of the High Court in *Ascot Investments Pty Ltd v Harper* have been cited in a number of cases to support the treatment of trust property as that of a party to a marriage where:

(1) the trustee is properly regarded as the alter ego or puppet of the party to the marriage such that the party is able to vest the property of the trust in himself or herself (see [17.15.273]); or

(2) the trust arrangement is a sham (see [17.15.275]).

The apparent inconsistency with basic family law rules that, first, the notion of property does not cover a mere ability to control economic benefits and, second, that the court can only deal with a spouse's own property, has been noted and explained by at least one commentator in the following terms:

> If a spouse has the ability unilaterally to vest property, or have property vested, in himself or herself (for example, through his or her position as trustee of a trust, or as governing director or controlling shareholder of a proprietary company), the court may require him or her to do so by an order under s 114, and thereby bring this property within the scope of [s 79 of the *Family Law Act 1975* (Cth)]. By treating an ability to vest property as if this power has been exercised, the court is simply taking a short cut and deeming what can be done as in effect done for the purpose of s 79.[2]

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1 *Ascot Investments Pty Ltd v Harper* (1981) 148 CLR 337; 55 ALJR 233, 354–355 (Gibbs J) (CLR). See also *In Marriage of Ashton* (1986) 11 Fam LR 457 (FamCAFC); *In Marriage of Stein* (1986) 11 Fam LR 353 (FamCAFC).

2 See Anthony Dickey, *Family Law* (Thomson Reuters, 6th ed, 2014) [40.190].

[17.15.271] Where the net assets of a trust are not regarded as part of property of a spouse, then the benefits derived from the trust may be taken into account as a financial resource under s 75(2) of the *Family Law Act 1975* (Cth) or as a factor to be taken into account under s 79(4). In *In Marriage of Reynolds* (unreported, FamCAFC, 1856 of 1886, 27 April 1990) it was emphasised that:

> [T]he question whether the property of the trust is in reality the property of the parties or one of them or a financial resource of the parties or one of them is a matter dependent upon the facts and circumstances of each particular case including the terms of the relevant Trust Deed.[1]

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1 *In Marriage of Reynolds* (unreported, FamCAFC, 1856 of 1886, 27 April 1990) 77 (Simpson J).

Trust Property Treated As Property of Spouse

Trust and Alter Ego or Puppet of Spouse

[17.15.272] The independence of a trust, the degree of control exercised over the trust and the ability to benefit from the trust by either party to a marriage, need to be assessed to determine whether a spouse, in reality, is the de facto owner of the assets of the trust. The rules as to where the real power rests to control the assets of a trust are set out in the trust deed. In addition to the trustee, some trusts have an appointor who generally has the right to remove or appoint trustees and may even change the terms of the trust deed. The High Court stated in *Ascot Investments Pty Ltd v Harper* (1981) 148 CLR 337; 55 ALJR 233, in the context of a company, that the court will take into account both the real and apparent independence of the directors and the degree of control exercised over the company by either party to the marriage.[1]

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1 *Ascot Investments Pty Ltd v Harper* (1981) 148 CLR 337; 55 ALJR 233, 355–356 (Gibbs J) (CLR).

[17.15.273] The Family Court has, in a number of cases, held that the assets of a trust are, in reality, the assets of the party to the marriage who is able to control the trust and apply the income and assets of the trust for his or her own benefit. In *In Marriage of Ashton* (1986) 11 Fam LR 457, the husband was not a named beneficiary of the trust. However, he was the beneficial owner of all of the shares in the trustee company and the appointor of the trust, able to remove the trustee and appoint a new trustee. Although not a named beneficiary of the trust he had benefited from the trust via a loan and distributions made to other discretionary trusts of which he was a beneficiary. Although under the trust deed the appointor was prevented from being the trustee of the trust, the husband had initially been the trustee of the trust and the Court found that on a proper construction of the deed he could be both appointor and trustee. It was conceded that the husband was in full control of the assets of the trust. The trial judge treated the assets of the trust as those of the husband and ordered that the husband appoint himself trustee under the deed. The Full Court held that:

> [H]aving regard to the powers and discretions which the husband has, and having regard to what had in fact taken place, for the purposes of s 79 [of the *Family Law Act 1975* (Cth)], the husband's power of appointment, and all the attributes it carries with it, amounts to de facto ownership of the property of the trust. His Honour's order that he should appoint himself trustee so as to make a requisite payment was not contrary to the trust deed on its proper construction, nor did it require the husband to deal with property which was not his own … The powers which the husband has in the Ashton Family Settlement give him control of the trust either as trustee or through a trustee which is his creature, and at the same time he is able to apply all the income and property of the trust for his own benefit. In my opinion, in a family situation such as the one here, this court is not bound by formalities designed to obtain advantages and protection for the husband who stands in reality in the position of the owner. He has de facto legal and beneficial ownership.[1]

The nature of the husband's interest in the trust, which was itself a beneficiary of the Ashton Family Settlement, or in any corporate beneficiary, is not discussed in the case. The Court simply said "[t]here is nothing to prevent the husband from holding the overwhelming majority of the shares in such a company or from having the greater interest in such a trust. Furthermore, as long as the distribution is made to the company or the trust the husband can get the full benefit of such a distribution".[2]

After quoting the well cited passage of Gibbs J in *Ascot Investments Pty Ltd v Harper* (1981) 148 CLR 337; 55 ALJR 233 (see [17.15.270]) the Court said that no person other than the husband had any real interest in the property or income of the trust except at his will, therefore the husband had de facto legal and beneficial ownership of the property of the trust.[3]

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1 *In Marriage of Ashton* (1986) 11 Fam LR 457 (FamCAFC), 462 (Strauss J).

2 *In Marriage of Ashton* (1986) 11 Fam LR 457 (FamCAFC) 462 (Strauss J).

3 *In Marriage of Ashton* (1986) 11 Fam LR 457 (FamCAFC), 462 (Strauss J). Note that the case as reported suggests that the trust was a unit trust the units in which were owned by a discretionary family trust and possibly the husband directly.

[17.15.273.3] In *In Marriage of Stein* (1986) 11 Fam LR 353 the trustee company was found to be a mere puppet of the husband who had the power to apply the income and property of the trust for his own benefit. In these circumstances the Full Court of the Family Court found that the trial judge had jurisdiction to make an order which required the husband to pay a sum out of the assets of the trust through the exercise of his control over the trustee company. In reaching that conclusion the Court appears to have been influenced by statements made by the husband to the effect that he was the effective owner of the business, and the fact that he obtained a loan from the trust which the Court took as indicating the degree of control the husband exercised through the trustee company of which he and his accountant were directors.

Similarly, in *In Marriage of Goodwin* (1990) 101 FLR 386 the property of a family trust was treated as property of the husband in circumstances where the husband had the sole power of appointment of the trustee; the trustee was an entity under his control (despite the fact that the husband's co-directors were the husband's accountant and/or solicitor); and of which he was a beneficiary to whom the trustee could make payments exclusively. The fact that the trust deed was amended after separation to exclude as beneficiaries the wife and her children was found by the Full Court of the Family Court to be further evidence that the husband controlled the trust.

In *In Marriage of Davidson [No 1]* (1990) 101 FLR 367 the husband was the appointor of a family trust with power to remove the trustee and appoint a new trustee. He was also a director of the trustee company along with his secretary but was not a beneficiary of the trust. The husband used the trust to make distributions to his wife and grandchildren who would lend such distributions to him interest free and which had not been repaid. It was held by the Family Court that the trustee was the husband's alter ego and should be included in his property pool. There was no evidence as to whether the husband could benefit from distributions made to a company or trust of which he was a shareholder or trustee and which was controlled by him as was the situation in *In Marriage of Ashton*. That decision was upheld by the Full Court[1] and in

May 1991 the High Court dismissed an application for special leave to appeal from the decision of the Full Court.

In *In Marriage of Harris* (1991) 104 FLR 458 the husband was the appointor and guardian of a family trust and also a beneficiary. He was a director of the trustee company together with the wife and their eldest son. As appointor he was able to replace the trustee. For practical purposes all dispositions of income and capital were under the complete control of the guardian. The Full Court of the Family Court found that the husband had full power of control over the trustee and over the assets of the family trust and was entitled to apply all these assets to his own use and benefit. In these circumstances the rights, powers and interests which the husband had in the family trust constituted property.

In *In Marriage of Webster* (1998) 24 Fam LR 198 the assets of a trust were treated by the wife as property on the basis that she would effectively control the trust on her mother's death. The directors and shareholders of the trustee company were three accountants and the appointor a company in which the wife had no interest until certain events occurred. The wife's mother, the wife and the children were income and capital beneficiaries as well as a company controlled by the wife. However, the trust was established to benefit the wife's mother during her lifetime by the provision of income and the wife and her children on her mother's death. It is not clear from the case whether this was reflected in the trust deed. Both the trial judge and the Full Court of the Family Court accepted a valuation of those assets at a discount to their present value because of her mother's life interest.

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1 *In Marriage of Davidson [No 2]* (1990) 101 FLR 373 (FamCAFC).

[17.15.273.7] In *Coventry v Smith* (2004) 181 FLR 220; [2004] FamCA 249 the interest of the husband in a trust of which his mother was the trustee was treated as the husband's property. In that case the husband, the wife and their issue were income beneficiaries of the trust and it was found that the husband had a vested interest in the capital of the fund, subject to divestiture in the event of his death prior to the distribution date. Amendments made to the trust deed by the mother to revoke the husband's power to remove the trustee and appoint a new trustee were held by the Full Court of the Family Court to be beyond power. In these circumstances it was within the husband's power to replace the trustee and nominate an immediate distribution date to access the property of the trust.

The issue was considered extensively in *Stephens v Stephens* (2007) 212 FLR 362; [2007] FamCA 680. In that case, a trust had been established by the husband prior to the marriage. The husband executed a deed, early in the marriage, to relinquish his position as a beneficiary of the trust, which was done as a means of reducing land tax obligations (the 1983 Deed). Late in the marriage, at a time when the wife alleged the marriage was failing, the husband took steps that resulted in the capital and income of the first trust being transferred to trusts created for each of the four children. It was contended by the husband that the deed relinquishing his position of beneficiary was irrevocable, and that the trial judge erred in holding that the assets of the Trust should be included actually or notionally in the pool of assets available for distribution between the parties.

In providing his decision, Bryant CJ noted:

> It is settled law that a person who is a trustee and a beneficiary can be treated as controlling the assets of the trust sufficient to treat the trust property as belonging to him or her and, in appropriate cases, to make orders directly effecting the trust property.[1]

Bryant CJ continued then referring to *In Marriage of Ashton* (1986) 11 Fam LR 457, *In Marriage of Davidson [No 1]* (1990) 101 FLR 367, *In Marriage of Goodwin* (1990) 101 FLR 386, *In Marriage of Webster* (1998) 24 Fam LR 198, *JEL v DDF* (2000) 163 FLR 157; [2000] FamCA 1353 and *Milankov v Milankov* (2002) 28 Fam LR 514; [2002] FamCA 195 before stating:[2]

> 43. These cases are in my view authority for the proposition that, at least on its face, and absent any other factors, a party who is the trustee of a discretionary trust, or has the capacity to appoint himself as trustee, and is also a beneficiary, or who has the capacity to become a beneficiary or become a majority shareholder in a company (who is or can become a beneficiary) can have the assets of the trust treated as if they are his or her own property. This has been the jurisprudence in the Family Court at least since [*In Marriage of Kelly [No 2]* (1981) 7 Fam LR 762] was decided.
>
> ...
>
> 44. Were it otherwise, it is obvious that a party could, by simply acquiring or placing assets in a discretionary family trust, effectively avoid an order being made which would enable the other party to share in the property owned by the trust.
>
> ...
>
> 45. The jurisprudence on this issue is not limited to family law authority.

Bryant CJ further noted that the facts of this case were clearer than those to which he had referred (identified above), that is, prior to 1983, the husband was the trustee and one of the beneficiaries of the Trust, and he removed himself as a beneficiary of the Trust by virtue of the 1983 Deed. Bryant CJ noted that the trial judge did not find that the Trust was the husband's alter ego, but it was not necessary for him to do so. Bryant CJ went on to note the following findings of the trial judge:

> Looking at the history of the Trust, the husband clearly had the benefit of the Trust assets.[3]
>
> ...
>
> However, in the alternative there can be no question that the level of control that the husband has is such that the assets of the Trust can be treated as a financial resource of the husband.[4]
>
> ...
>
> [T]he husband has historically benefitted from the assets and income of the Trust and that can continue certainly via the children. Further, he is clearly able to benefit the children directly. Thus I find at the very least the Trust assets can be taken into account as a financial resource of the husband, *but of course that is not the basis on which I proceed.*[5]

Bryant CJ forms the conclusion that the husband could be reinstated by a beneficiary notwithstanding the 1983 Deed, agreeing with Warwick J, going on to say:

> Once it is accepted that the effects of the 1983 Deed can be reversed, this is a case like many others where assets are held in discretionary trust and the husband has "control" as trustee and is capable of having the means distributed to him as a beneficiary.[6]

The case was subsequently upheld in the High Court as *Kennon v Spry* (2008) 238 CLR 366; 83 ALJR 145; 1 ASTLR 271; [2008] HCA 56.

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1 *Stephens v Stephens* (2007) 212 FLR 362; [2007] FamCA 680, [34] (agreeing with Warwick J, with Finn J dissenting).
2 *Stephens v Stephens* (2007) 212 FLR 362; [2007] FamCA 680, [43]–[45].
3 *Stephens v Stephens* (2007) 212 FLR 362; [2007] FamCA 680, [50] (Bryant CJ) (citing *In Marriage of Kelly [No 2]* (1981) 7 Fam LR 762).
4 *Stephens v Stephens* (2007) 212 FLR 362; [2007] FamCA 680, [51] (Bryant CJ) (citing *In Marriage of Kelly [No 2]* (1981) 7 Fam LR 762).
5 *Stephens v Stephens* (2007) 212 FLR 362; [2007] FamCA 680, [52] (Bryant CJ (emphasis added by Bryant CJ)) (citing *In Marriage of Kelly [No 2]* (1981) 7 Fam LR 762).
6 *Stephens v Stephens* (2007) 212 FLR 362; [2007] FamCA 680, [54] (Bryant CJ).

[17.15.274] The parties' degree of control over a trust is the key issue for determining whether a party's interest in a trust is property or a financial resource. Control is often assessed and commented upon by the expert in preparation of their valuation of the trust. The expert will typically have access to the following documentation in assessing the level of control exercised by a party to a marriage:

(1) the legal structure and constitutional documents of the entities – the trust deed, deeds of variation and memorandum and articles of the corporate trustee and details of the various officers;

(2) the minutes of meetings of the trustees;

(3) trust taxation returns which provide details of taxable income and distributions made to beneficiaries;

(4) income and expenditure accounts and balance sheets of the trust; and

(5) annual returns of the corporate trustee.

However, the issue of control is a matter of fact for determination by the Family Court. For this purpose, the Court will review the following:

(1) the benefits received from the trust by each party, including loans and salaries etc;

(2) the distribution history – the Court may also consider distributions to others who are aligned with either party to a marriage;

(3) the degree of affiliation between a party and the trustee, appointor or settlor and whether a party has been involved in any variations to the trust deed or has the power to make such variations;

(4) the capacity to borrow against trust funds; and

(5) the possibility of future control over trust assets.

Trust a Sham

[17.15.275] Sham arrangements which have been brought into being as a device to assist one party to evade his obligations under the *Family Law Act 1975* (Cth) may be disregarded. [1] There are a number of cases where it has been argued that particular transactions entered into by a party to a marriage are a sham.

1 For example, see *Ascot Investments Pty Ltd v Harper* (1981) 148 CLR 337; 55 ALJR 233.

Trust Property Financial Resource or s 75(2)(o) Factor

General

[17.15.276] There are circumstances in which the property of a third party can be taken into consideration as property of a party to a marriage: see [17.15.277]–[17.15.278]. Where this is not the case the property of a third party may nonetheless, be taken into account as a financial resource of a party to a marriage, and the extent to which that party can control that property is relevant to this question.

Financial Resource

[17.15.277] Where the assets of an entity are to be taken into account as a financial resource of a party, the financial resource is not necessarily the capital value of those assets but the financial benefit the party derives from those assets. In *In Marriage of Kelly [No 2]* (1981) 7 Fam LR 762 the husband and wife formed a company and a family trust designed to minimise the incidence of death duty. The company was owned by the wife (one share), the accountant (one share) and the family trust (78 shares). The directors of the company, who were also the trustees of the trust, were the wife, the accountant and the husband's brother. In so far as is relevant, the income beneficiaries were the wife and children and the capital beneficiaries the children only. The husband was neither a beneficiary nor the appointor of the trust. The husband transferred to the company a portion of the pastoral property owned by him and the company subsequently acquired further land. The company's property was leased to the husband who carried on the farming operations.

The trial judge found that as a matter of law the husband had neither control over the company and the trust nor any legal interest in either and that the assets of the company and trust were not his property. However, he found that it was equally obvious that the husband had, as a matter of fact, full control over the administration of both and that this was always intended. The trial judge accepted that the husband received no financial advantage from his control of the company or the trust, but was of the view that there was evidence that he received indirect personal financial advantage in the sense that distributions to the wife went towards maintaining the wife and family and effectively saved the husband meeting that expenditure. Based on this finding he concluded that he should take into account the assets of the company and trust as a financial resource.

The Full Court upheld the decision of the trial judge but in so doing was required to consider whether the trial judge had erred in taking into account the capital value of the assets of the trust and company as opposed to the financial benefit he derived from those assets. The Full Court said:

> The financial resource which a person has is not necessarily to be equated with the asset or income from which benefit is derived. For example, if the rental of a property were regularly paid to a person under a family arrangement, the receipt of the rent may be regarded as a resource of the person concerned, not necessarily the capital value of the property. It is important, therefore, to define what benefit a person has received in the past and what is likely to be received in future. Where there is factual control, that may enable the person concerned not only to ensure the continuation of past benefits, but also to expand to some extent the possibility of future benefits within the limits of the control, but neither legal or factual control is essential … This Court accepts that the financial resource of the husband was not the capital asset value, but the financial benefit he derived from those assets in whatever form, either to relieve him of an obligation or to supply some want or deficiency which he would otherwise have to meet from his own funds.[1]

In *In Marriage of Webster* (1998) 24 Fam LR 198, the wife was the appointor and a beneficiary of a trust which had been set up for the benefit of the children. The wife offered to make an undertaking to the Full Court of the Family Court not to make any distribution from the trust other than to the children which was accepted by the trial judge. The judge accepted that the assets of the trust were a financial resource and did not form part of the assets of the wife. The decision took into account the peculiar factual circumstances surrounding the establishment of the trust namely, that it was established as part of the resettlement of a larger trust following the death of the wife's father and that its establishment had the support of the husband at the time. The Full Court found that "in the somewhat unusual circumstances of the case"[2] it was open to the trial judge to treat the assets of the trust as a financial resource rather than property of the wife.

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1 *In Marriage of Kelly [No 2]* (1981) 7 Fam LR 762 (FamCAFC), 773 (the Court).

2 *In Marriage of Webster* (1998) 24 Fam LR 198 (FamCAFC), 211 (the Court).

Section 75(2)(o) Factor

[17.15.278] In *Milankov v Milankov* (2002) 28 Fam LR 514; [2002] FamCA 195 the Full Court of the Family Court held that it was open to the trial judge to find that the husband's interest in a family trust controlled by his father was a factor to be taken into account under s 75(2)(o) of the *Family Law Act 1975* (Cth). In reaching this conclusion the trial judge found, amongst other things, that the husband would control the trust after his father's death.

In that case the primary beneficiaries of a family trust were the husband, the wife and the husband's parents. The general beneficiaries were the lineal descendants of the husband's father. The appointor of the trust was the husband's father until his death and then the husband. The directors of the trustee company were the husband and his father. In order to distance himself from the trust after the separation, the family's accountant replaced the husband as the succeeding appointor and the trustee company changed to one in which the husband was neither a shareholder nor a director.

The trial judge held that as the husband did not control the trust, the trust assets were not a financial resource. Nor was the expectancy of an inheritance a financial resource. However, the trial judge found that the husband would effectively inherit assets at least equal to the assets of the trust upon his father's death and that this should be taken into account as a factor under s 75(2)(o). In reaching this conclusion the trial judge had regard to the fact that:

(1) the husband had spent a considerable time managing the trust;

(2) the husband and his siblings would not be provided for equally;

(3) after his father's death the appointer would ensure that the husband took control of the trust's assets (which would have been the case but for the restructuring); and

(4) there had been no falling out with his parents.

Breach of Trust

[17.15.279] A recurrent argument on appeal in cases where the assets of a family trust have been treated as property of a party to a marriage, is whether a spouse's ability to vest property in themselves, or make payments to the other spouse from the assets of the trust, would involve the trustee or appointor being in breach of their fiduciary duties to the other beneficiaries of the trust. To date the Family Court has not regarded the spouse as being so constrained.[1]

The issue was considered in *Stephens v Stephens* (2007) 212 FLR 362; [2007] FamCA 680. It was argued that the trial judge erred in law by holding that by applying the assets of the Trust in the husband's favour or to satisfy or fund an order for payment to the wife the husband would not be acting in breach of a trust or in the fraudulent exercise of his powers as trustee.

The trial judge noted that the issue of treating the assets of the of the trust as property of the parties and whether this process or application of those assets constitutes a breach of trust and/or a fraud on the powers of the trustee and/or appointor was raised in the cases of *In Marriage of Ashton* (1986) 11 Fam LR 457 and *In Marriage of Davidson [No 1]* (1990) 101 FLR 367. The trial judge also went on to refer to cases addressing a fraud on a power, being *Vatcher v Paull* [1915] AC 372, *Re Skeats' Settlement* (1889) 42 Ch D 522 and *Re Crawshay (Deceased)* (1948) Ch 123) as authority for the proposition that a power such as a power of appointment should not be exercised for an improper purpose. Although Bryant CJ stated:

> It is settled law that a person who is a trustee and a beneficiary can be treated as controlling the assets of the trust sufficient to treat the trust properly as belonging to him or her and, in appropriate cases, to make orders directly affecting the trust property.[2]

Finn J noted that there was substance to the submissions made for the husband that when considering decisions of the Family Court of Appeal and the English Courts it is necessary to bear in mind the distinction between the power to appoint a trustee and power to appoint property (also noting it was not necessary for him to consider whether the proposed orders would represent a breach of trust)[3] and Warwick J noted that there was merit in the submissions for the husband to the effect that the trustee must not benefit himself directly or indirectly in the absence of clear words entitling him to do so, although also noting that as it was only considered as an alternative argument by the trial judge there were no consequences.[4]

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1 *In Marriage of L and F* (2000) 163 FLR 157; [2000] FamCA 1353 (FamCAFC); *BP v KS* (2002) 177 FLR 354; [2002] FamCA 1454 (FamCA); *Milankov v Milankov* (2002) 28 Fam LR 514; [2002] FamCA 195 (FamCAFC); *Thurlstane (Aust) Pty Ltd v Andco Nominees Pty Ltd* (unreported, NSWCA, Meagher, Powell and Cole JJA, CA 4032 of 1995, 27 October 1997), the sequel to *In Marriage of Davidson [No 2]* (1990) 101 FLR 373 (FamCAFC); *In Marriage of Goodwin* (1990) 101 FLR 386 (FamCAFC).

2 *Stephens v Stephens* (2007) 212 FLR 362; [2007] FamCA 680, [34] (Bryant CJ).

3 *Stephens v Stephens* (2007) 212 FLR 362; [2007] FamCA 680, [143] (Finn J).

4 *Stephens v Stephens* (2007) 212 FLR 362; [2007] FamCA 680, [333]–[336].

[17.15.279.1] The High Court case of *Kennon v Spry* (2008) 238 CLR 366; 83 ALJR 145; 1 ASTLR 271; [2008] HCA 56 discussed the question of whether payment to the wife would amount to a breach of trust or fraudulent exercise of powers of trustee was not expressly addressed (at least not in those terms). In relation to the issue, French CJ noted:

> As to the position of the other beneficiaries, it has long been accepted that in some circumstances the Family Court has power to make an order which will indirectly affect the position of a third party. That acceptance ... predated the enactment of [Pt VIIIAA of the *Family Law Act 1975* (Cth)].[1]

Part VIIIAA of the *Family Law Act 1975* allows the Court in relation to the property of a party to a marriage to make an order under s 79 or s 114, or grant an injunction under s 1145.

Gummow and Hayne JJ noted:

> If the Husband wishes to satisfy his obligations to the wife under order 4 [which prescribed the amount the husband was required to pay the wife] by recourse to the augmented assets of the Trust then it is open to him to approach the court for an appropriate order to assist him in doing so. ... It would be for the Court to determine whether, putting aside the interests of the children of the marriage for the reasons already given, it was just and equitable to make the order having regard to the interests of any third parties who may also fall within the defined class of "beneficiaries".[2]

And Kiefel J stated:

> The primary judge found that the wife should receive a sum of money ... The problem that faced his Honour was how the husband could meet that sum from the assets at his disposal. His Honour's answer to that question was it could, and should, come from the Trust property. His Honour found that the wife should be paid out of the Trust, but considered that the result could only be effected by the husband. That was not a correct view, having regard to [s 85A(1) of the *Family Law Act 1975*].
>
> ...
>
> Section 85A(1) provided the power and the means by which the trial judge's findings and intentions could be carried into effect.
>
> ...
>
> It has long been accepted that the third party interests could be altered by courts dealing with property the subject of nuptial settlement.[3]

1 *Kennon v Spry* (2008) 238 CLR 366; 83 ALJR 145; 1 ASTLR 271; [2008] HCA 56, [68].
2 *Kennon v Spry* (2008) 238 CLR 366; 83 ALJR 145; 1 ASTLR 271; [2008] HCA 56, [138].
3 *Kennon v Spry* (2008) 238 CLR 366; 83 ALJR 145; 1 ASTLR 271; [2008] HCA 56, [234]–[236].

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Revenue Law

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Deductions

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Common Specific Deductions

Interest

[31.4.970] The deductibility of interest expense is ordinarily determined by the purpose for which the money was borrowed. Interest is an allowable deduction only where money is borrowed for the purpose of producing assessable income. A "rigid tracing" of funds is not always necessary in ascertaining how the borrowed monies have been applied.[1]

The purpose test owes its origin to the High Court decision in *Federal Commissioner of Taxation v Munro* (1926) 38 CLR 153. The taxpayer was the landlord of freehold retail premises in Melbourne. The taxpayer had an object of starting a business in Sydney and for that purpose caused a company to be incorporated. The taxpayer borrowed an amount from a bank which she or he used to subscribe for shares in the new company. The borrowing was secured by a mortgage of the freehold premises. The company issued 10 percent of its capital to the taxpayer and 90 percent (at the taxpayer's direction by way of gift) to the taxpayer's two sons.

The issue for determination by the Court was whether the interest paid on the loan from the bank was deductible. The High Court ultimately concluded that the primary test for characterising the interest expense was the purpose for which the funds were applied and agreed that they were applied to refinance a gift, not to produce assessable income. The High Court rejected an argument by the taxpayer which has now become known as the "but for" test. In effect, the taxpayer's argument that "but for" payment of the interest the rental income would have ceased because the bank would have exercised its power of sale was rejected as being an appropriate test to determine the deductibility of the interest expense. Rather, the High Court said the primary criterion for determining deductibility was the purpose for which the borrowed funds were applied.[2]

The focus on the immediate purpose of the borrowing was reaffirmed by the Federal Court in *Hayden v Commissioner of Taxation* (1996) 68 FCR 19; 33 ATR 352. In *Hayden v Commissioner of Taxation* the taxpayer was the executor of a deceased estate who had lent $150,000 to the estate to enable it to pay an order against the estate under the testator's family maintenance provisions of the *Succession Act 1981* (Qld). The taxpayer claimed a deduction for the interest paid by the estate to her on the basis that the interest was incurred to preserve the estate's income-earning assets rather than selling them to pay the court order. Spender J in the Federal Court held that the interest was not deductible to the estate, concluding that the focus must be on the use to which the borrowed funds are put. Here the borrowed funds were used to discharge an obligation by the taxpayer. That obligation did not produce assessable income but was entirely private in nature. Spender J held, applying the principle in *Federal Commissioner of Taxation v Munro*, that the mere fact that the borrowing of funds permitted income-producing assets to remain as part of the estate so that the income stream to the estate was not diminished did not render the interest deductible.[3] The Court declined to follow *Begg* *v Deputy Federal Commissioner of Taxation (SA)* [1937] SASR 97; (1937) 4 ATD 257 in which a court held that interest on borrowings by a personal representative to pay estate duty were deductible on the basis that the estate was thereby able to retain income-producing assets.

In *Kidston Goldmines Ltd v Commissioner of Taxation* (1991) 30 FCR 77; 22 ATR 168 the taxpayer borrowed to finance working capital, the operation of gold mining (which produced exempt income), to refinance existing borrowings and to finance the payment of dividends. The taxpayer had also invested part of the borrowings on a temporary basis in the short-term money market in order to derive assessable interest income. The taxpayer sought a deduction for the interest paid on its bank loans and facilities as being referable to the conduct of a business which, among other things, derived assessable interest income from the short-term money market. Hill J indicated that in most cases, the purpose of the borrowing is ascertained from the use to which the borrowed funds were put. His Honour went on to say that where the funds were employed in a business devoted to the production of assessable income it may well be said that interest on moneys borrowed to secure capital or working capital is clearly deductible. Hill J concluded that if the business is devoted to gaining both assessable income and exempt income some part of the interest outgoing is deductible and it is necessary to carry out a fair and reasonable apportionment of the interest outgoing which could only be carried out by reference to a tracing approach based on the use of the funds.

The occasion for the recurring liability to pay interest is the loan agreement made between the taxpayer and the lender. So long as the purpose for which the loan agreement was entered into by the taxpayer satisfies the tests of relevance and incidence in the first limb of s 8-1 of the *Income Tax Assessment Act 1997* (Cth), the interest will continue to be deductible because it is inherently an expense incurred on a revenue account.[4] Subject to the entry into the loan agreement satisfying the test of relevance and incidence in the positive limb of s 8-1 of the *Income Tax Assessment Act 1997* at the time the loan agreement was entered into, the interest paid under that loan agreement continues to be deductible notwithstanding that the asset acquired with the borrowed funds, which was used to generate assessable income or to conduct a business for that purpose, has been disposed of by the taxpayer prior to the obligation to pay interest under the loan agreement ending. The mere cessation of business well prior to the termination of the obligation to pay interest under the loan agreement will not deprive the interest outgoing of its deductible character, so long as there is a sufficiently proximate connection between the activities of the business and the incurring of the interest outgoing in a causal or purposive sense rather than in a temporal sense.[5]

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1 *Federal Commissioner of Taxation v Roberts* (1992) 37 FCR 246; 23 ATR 494 (FC).

2 *Federal Commissioner of Taxation v Munro* (1926) 38 CLR 153, 171 (Knox CJ), 197 (Isaacs J), 217–218 (Starke J).

3 *Hayden v Commissioner of Taxation* (1996) 68 FCR 19; 33 ATR 352 (FCA), 28 (Spender J) (FCR).

4 *Steele v Deputy Commissioner of Taxation* (1999) 197 CLR 459; 73 ALJR 437; 41 ATR 139; [1999] HCA 7, [26] (Gleeson CJ, Gaudron and Gummow CJ), adopting and applying *Texas Co (A'asia) Ltd v Federal Commissioner of Taxation* (1940) 63 CLR 382; 5 ATD 298, 468 (Dixon J) (CLR).

5 *Federal Commissioner of Taxation v Brown* (1999) 43 ATR 1; [1999] FCA 721 (FC).

[31.4.980] Interest incurred on borrowings used to finance an interest-free loan to a company is deductible if the purpose of the borrowing is to enable the company to declare dividends to a lender.[1] However, the mere advance of funds interest free without evidence of potential for income generation will result in the interest on borrowings to fund the advance being non-deductible.[2] In *Federal Commissioner of Taxation v Total Holdings (Aust) Pty Ltd* (1979) 43 FLR 217; 9 ATR 885 the taxpayer borrowed money from its holding company at a rate of 3 percent per annum and on-lent those funds to its subsidiary on an interest-free basis for the overriding purpose of financing its group company operations in Australia. The taxpayer argued that the purpose of the loan was to render the subsidiary profitable as quickly as possible. There was evidence that the subsidiary company might be disposed of for a capital profit if it became profitable. The Commissioner of Taxation argued that the purpose of the interest-free loan was to increase the capital value of the subsidiary rather than to derive assessable income in the form of dividends from the subsidiary. The Full Federal Court concluded that the loan from the holding company and the interest incurred on that loan to the holding company was relevant and incidental to the conduct of the business, not only of the taxpayer but of the Total group of companies as a whole because the subsidiary was expected to generate profits which in turn would lead to the derivation of assessable dividends by the taxpayer from its subsidiary.[3]

The principle adopted in *Federal Commissioner of Taxation v Total Holdings of Australia Ltd* would also be applicable in comparable circumstances, for example, to borrowings used to finance an interest-free loan to a unit trust from a unit holder.

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1 *Federal Commissioner of Taxation v Total Holdings (Aust) Pty Ltd* (1979) 43 FLR 217; 9 ATR 885 (FCAFC).

2 *Sheil v Federal Commissioner of Taxation* (1987) 18 ATR 900 (FCA).

3 *Federal Commissioner of Taxation v Total Holdings (Aust) Pty Ltd* (1979) 43 FLR 217; 9 ATR 885 (FCAFC), 227–229 (Lockhart J) (FLR), 218 (Northrop and Fisher JJ agreeing) (FLR). See also Australian Taxation Office, *Income Tax: Deduction for Interest on Borrowings to Fund Share Acquisitions*, IT 2606, 16 August 1990.

[31.4.990] Interest may be non-deductible if the indirect purpose of the borrowing is a non-income producing purpose.[1] The relevance of a taxpayer's subjective motives has been considered above: see [31.4.590]. The application of this principle to the deductibility of interest is illustrated in *Ure v Federal Commissioner of Taxation* (1981) 50 FLR 219; 11 ATR 484 (see [31.4.590]) and *Federal Commissioner of Taxation v Ilbery* (1981) 58 FLR 191; 12 ATR 563.

In *Federal Commissioner of Taxation v Ilbery* the taxpayer borrowed money at 14 percent per annum but on a pre-agreed contractual condition that if future interest that was payable under the loan agreement was prepaid by the taxpayer, then interest for the remaining term of the loan would be reduced to a lower rate of interest. The effect was to give the taxpayer credit for the interest payment as the present value of the loan reflected the interest payment. The taxpayer borrowed the money to acquire real estate and shortly after borrowing the money the taxpayer exercised his option pursuant to the terms of the loan agreement to pre-pay five years' future interest. The interest rate applicable to the balance of the term of the loan was reduced to 4 percent The lender then assigned the loan to a company controlled by the taxpayer and his wife for a consideration equal to the present value of the future payments still required to be made under the loan. Toohey J (Northrop and Sheppard JJ agreeing) concluded by reference to objective criteria that the purpose for prepaying the interest was not to gain or earn assessable income but rather to obtain a tax advantage.[2] Toohey J did not treat subjective purpose as being the sole criterion for determining deductibility but rather concluded that purpose was only "relevant to throw light upon the character of a payment".[3] That is, Toohey J concluded that purpose was only part of the essential character test of deductibility of an outgoing which was incurred voluntarily.[4]

Interest is ordinarily deductible notwithstanding that the income from an investment may for a period be less than the interest incurred on borrowings financing the investment (ie where the investment is negatively geared).[5]

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1 *Fletcher v Federal Commissioner of Taxation* (1991) 173 CLR 1; 66 ALJR 11; 22 ATR 613; *Ure v Federal Commissioner of Taxation* (1981) 50 FLR 219; 11 ATR 484 (FCAFC).
2 *Federal Commissioner of Taxation v Ilbery* (1981) 58 FLR 191; 12 ATR 563 (FCAFC), 201–203 (Toohey J) (FLR).
3 *Federal Commissioner of Taxation v Ilbery* (1981) 58 FLR 191; 12 ATR 563 (FCAFC), 201 (Toohey J) (FLR).
4 See also *Commissioner of Taxation v Gwynvill Properties Pty Ltd* (1986) 13 FCR 138; 17 ATR 844 (FCAFC).
5 *Commissioner of Taxation v Janmor Nominees Pty Ltd* (1987) 15 FCR 348; 19 ATR 254 (FC).

[31.4.1000] A change in the use of borrowed moneys affects the deductibility of the interest outgoing from the moment of that change in use.[1] The purpose of a borrowing is determined objectively by reference to the application of the borrowed moneys. Hence a change in the use of the borrowed moneys may result in interest, which was originally deductible, becoming non-deductible or interest, which was originally non-deductible, becoming deductible after the change in use has occurred.

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1 *Commissioner of Taxation (Cth) v Riverside Road Lodge Pty Ltd (in liq)* (1990) 23 FCR 305; 21 ATR 499 (FC), 318–319 (the Court) (FCR); *Texas Co (A'asia) Ltd v Federal Commissioner of Taxation* (1940) 63 CLR 382; 5 ATD 298, 468 (Dixon J) (CLR); *Commissioner of Taxation v Roberts* (1992) 37 FCR 246; 23 ATR 494 (FC); *Hayden v Commissioner of Taxation* (1996) 68 FCR 19; 33 ATR 352 (FCA), 23–25 (Spender J) (FCR).

[31.4.1010] A change in the character of an asset acquired using borrowed funds can affect the deductibility of interest payable on those funds. For example, in *Commissioner of Taxation v Riverside Road Lodge Pty Ltd (in liq)* (1990) 23 FCR 305; 21 ATR 499 the taxpayer borrowed money which it then used to construct a motel which the taxpayer subsequently operated for about 14 years after its construction. Nine years after the construction of the motel the taxpayer sold the motel freehold to a trustee of a unit trust established by the taxpayer in which the taxpayer's shareholders became the unit holders. The date possession was given was

February 1979. After the motel freehold was transferred from the taxpayer to the unit trust the taxpayer continued to conduct the motel business under a lease of the freehold of the premises from the trustee of the unit trust. The purchase price was lent by the taxpayer to the purchaser interest free and the taxpayer continued to pay interest under the original loan for the purchase of the land and buildings until May 1979, when the original loan was refinanced. The taxpayer then paid interest under the new loan. The taxpayer sought a deduction for both the payments of rent made under the lease and for the interest paid on the original and the new loans after the transfer of the freehold to the unit trust trustee. The Court held that the essential character of the interest outgoings changed because the business which the taxpayer conducted changed from a freehold motel business to a leasehold motel business. The interest therefore ceased to be connected with the business of running a rented motel and was not deductible.[1] However, the Court allowed deductions for the interest between February 1979 and May 1979 under the original loan, as this interest was payable under the taxpayer's obligations as owner-operator of the motel.

1 *Federal Commissioner of Taxation v Riverside Road Lodge Pty Ltd (in liq)* (1990) 23 FCR 305; 21 ATR 499 (FC), 318–319 (the Court) (FCR).

[31.4.1020] Interest on funds borrowed to refinance partnership capital is deductible provided certain conditions are satisfied.[1] In *Yeung v Federal Commissioner of Taxation* (1988) 19 ATR 1006 interest on moneys borrowed to refinance an investment in a rental property was held to be deductible. The investors were deemed to be a partnership for taxation purposes as they were in receipt of income jointly, there being no partnership at general law and certainly no express partnership.

In *Commissioner of Taxation v Roberts* (1992) 37 FCR 246; 23 ATR 494 the partners in a firm of solicitors borrowed $125,000 from the firm's bank which they used to finance a "refund" of partnership capital. Each of the existing partners used their share of the "refund" for private purposes. The result was that the partnership's net assets were reduced by $125,000. After the refinancing, new partners were able to buy into the partnership at a reduced cost. The Commissioner denied deductions for interest to the extent that the interest related to the increased debt used to finance the refund. One of the existing partners, Mr Smith, and one of the incoming partners, Mrs Roberts, disputed the Commissioner's calculation of their share of the partnership's income. Hill J drew a distinction between partnership capital which is contributed by the partners and capital which is created by the revaluation of assets.[2] Hill J held that Mr Smith was entitled to a deduction for that part of his interest expense which was referable to the refund of his share of undistributed profit distributions and contributions of capital made by the partners.[3] However, to the extent that capital consisted of other items, such as a revaluation of partnership assets, interest on money borrowed to finance a repayment of capital would not be deductible. On the other hand, Mrs Roberts, the incoming partner, was allowed a deduction for all of her interest outgoing because it was characterised as an expense referable to the acquisition of her interest in the partnership which was an asset generating assessable income for her.

The Australian Taxation Office's views on the deductibility of interest under s 8-1 of the *Income Tax Assessment Act 1997* (Cth) following the "replacement of funds used in the business" test from *Commissioner of Taxation v Roberts* (1992) 37 FCR 246; 23 ATR 494 are set out in *Taxation Ruling TR 95/25*.[4] *Taxation Ruling TR 95/25* deals separately with common law partnerships, tax law partnerships, companies and individuals and, in respect of companies, it states that interest will be deductible if the borrowed monies are used to pay a dividend from profits arising from assessable income-producing activities or to buy back shares.

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1 *Yeung v Federal Commissioner of Taxation* (1988) 19 ATR 1006 (FCA); *Commissioner of Taxation v Roberts* (1992) 37 FCR 246; 23 ATR 494 (FC).

2 *Commissioner of Taxation v Roberts* (1992) 37 FCR 246; 23 ATR 494 (FC), 259–260 (Hill J) (FCR).

3 *Federal Commissioner of Taxation v Roberts* (1992) 37 FCR 246; 23 ATR 494 (FC), 259–260 (Hill J) (FCR).

4 Australian Taxation Office, *Income Tax: Deductions for Interest under Section 8-1 of the Income Tax Assessment Act 1997 Following Federal Commissioner of Taxation v Roberts* (1992) 37 FCR 246; 23 ATR 494, TR 95/25, 29 June 1995.

[31.4.1030] A prepayment of interest is ordinarily deductible provided the purpose of the borrowing to which the interest relates is the production of assessable income.[1] However, the timing of the deduction may be affected by statutory provisions in the *Income Tax Assessment Act 1936* (Cth).[2] Further, if a prepayment relates to a lengthy period then it may not be clear that the borrowing will be used to produce assessable income during the whole of the period in question.

Deductions for prepaid interest have been denied in some cases involving tax avoidance schemes. In *Commissioner of Taxation v Gwynvill Properties Pty Ltd* (1986) 13 FCR 138; 17 ATR 844 a prepayment of interest on a loan was made pursuant to a demand by an independent financier under the terms of a loan agreement between the financier and the taxpayer. After the prepayment of interest was made the loan was sold by the financier to an associate of the taxpayer at a heavily discounted price on its face value which took into account the loss of the right to the future income stream due to the prepayment of interest to the vendor of the loan (the independent financier). The Full Federal Court refused a deduction to the taxpayer for the prepayment of interest by reference to the purpose or motive for which the taxpayer made the prepayment of interest. Neaves J concluded that the transaction was inexplicable in order to "achieve the espoused business end of supplementing from an outside source the funds available to the taxpayer from its own resources".[3] Jackson J concluded that the prepayment of interest could only be explained as an attempt to obtain a large tax deduction in the year of income.[4]

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1 *Ure v Federal Commissioner of Taxation* (1981) 50 FLR 219; 11 ATR 484 (FCAFC); *Federal Commissioner of Taxation v Ilbery* (1981) 58 FLR 191; 12 ATR 563 (FCAFC).

2 The most notable of these is *Income Tax Assessment Act 1936* (Cth) s 82KZM. See "Tax Accounting" [31.5.140]–[31.5.540].

3 *Commissioner of Taxation v Gwynvill Properties Pty Ltd* (1986) 13 FCR 138; 17 ATR 844 (FC), 152 (Neaves J) (FCR).

4 *Commissioner of Taxation v Gwynvill Properties Pty Ltd* (1986) 13 FCR 138; 17 ATR 844 (FC), 156–157 (Jackson J) (FCR).

[31.4.1040] Interest expense is almost invariably revenue in nature. In *Texas Co (A'asia) Ltd v Federal Commissioner of Taxation* (1940) 63 CLR 382; 5 ATD 298 Dixon J commented that some kinds of recurrent expenditure made to secure capital or working capital are clearly deductible.[1] Under the Australian system interest on money borrowed for the purpose of producing assessable income forms a deduction as does the rent of premises and the hire of plant.

Hence interest incurred in financing the construction of an income-producing building has been held to be deductible notwithstanding that the interest was capitalised in the company's accounts.[2]

In *Steele v Deputy Commissioner of Taxation* (1999) 197 CLR 459; 73 ALJR 437; 41 ATR 139; [1999] HCA 7 the taxpayer acquired a property on which a racehorse training and agistment business was carried on. Her intention at the time was to build and operate a motel on the property. In January 1982 the taxpayer formed a partnership to carry out the motel development. She made enquiries relevant to the development concerning zoning, sewerage connection and attracting other investors. Work on the project ceased after April 1984. In December 1986, the taxpayer acquired her partner's interest in the property and later sold all of it in two parcels. The High Court held that interest was ordinarily a recurrent or periodic payment which secured the use of borrowed funds during the term of the loan and which did not ordinarily secure an enduring or structural advantage for the taxpayer. Accordingly, it was proper to regard the interest expense as a revenue item and the character of the interest expense was not altered by reason of the fact that the borrowed funds were used to purchase a capital asset (namely, the development site). The fact that the capital asset had not become and may never have become income producing was held to be irrelevant to the first limb of former s 51(1) of the *Income Tax Assessment Act 1936* (Cth) (now see s 8-1 of the *Income Tax Assessment Act 1997* (Cth)) as to whether it was an expense incurred in the course of gaining or producing assessable income.

In *Steele v Deputy Commissioner of Taxation* it was held that once it had been accepted that the interest expense was incurred in gaining or producing assessable income, notwithstanding that no assessable income had been derived during the year of income under consideration and no income may well have ever been derived, the fact that the incurring of the interest outgoing had produced no assessable income was not a reason to conclude that the interest was an outgoing of a capital nature.

Following *Steele v Deputy Commissioner of Taxation*, the Commissioner of Taxation published his opinion as to when interest incurred prior to derivation of assessable income will be deductible:[3]

(1) the interest is not incurred "too soon", is not preliminary to the income earning activities, and is not a prelude to those activities;

(2) the interest is not private or domestic;

(3) the period of interest outgoings prior to the derivation of relevant assessable income is not so long (taking into account the kind of income earning activities involved) that the necessary connection between outgoings and assessable income is lost;

(4) the interest is incurred with one end in mind: the gaining or producing of assessable income; and

(5) continuing efforts are made in pursuit of that end.

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1 *Texas Co (A'asia) Ltd v Federal Commissioner of Taxation* (1940) 63 CLR 382; 5 ATD 298, 468 (Dixon J) (CLR).

2 *Travelodge Papua New Guinea Ltd v Chief Collector of Taxes* (1985) 16 ATR 867 (National Court of PNG). But see *Steele v Deputy Commissioner of Taxation* (1999) 197 CLR 459; 73 ALJR 437; 41 ATR 139; [1999] HCA 7.

3 See Australian Taxation Office, *Income Tax: Deductions for Interest Incurred Prior to the Commencement of, or Following the Cessation of, Relevant Income Earning Activities*, TR 2004/4, 9 June 2004, [9].

[31.4.1050] Tax deductions for interest may be denied by specific statutory provisions. A number of specific statutory provisions may affect the deductibility of interest expenses. Most, but not all, of these provisions are of an anti-avoidance nature. In particular, deductions are denied for interest on money borrowed to finance the payment of personal superannuation contributions and certain life insurance premiums.[1] Deductions may also be denied for interest payable to non-residents,[2] and for interest on convertible notes, which is only deductible if certain conditions are satisfied.[3]

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1 *Income Tax Assessment Act 1997* (Cth) ss 26-80, 26-85.

2 *Income Tax Assessment Act 1997* (Cth) Pt 4-5 Div 820. See also *International Trade* "Thin Capitalisation" [24.4.1050]–[24.4.1950].

3 A "convertible note" is defined by *Income Tax Assessment Act 1936* (Cth) s 82L as including a note issued by a company which provides that the amount of the loan to the company which is evidenced, acknowledged or created by the note or to which the note relates is to be or may be converted into shares in the capital of the company or of another company or is to be redeemed by the allotment or transfer or acquisition of shares in a company, or by the application towards paying up the unpaid balance on shares issued by a company. The term also includes a note under which the holder or owner of the note is to have or may have, a right or option to have allotted or transferred to him or her or to some other person shares in the capital of a company. Interest is only deductible if the terms of the note satisfy the conditions in *Income Tax Assessment Act 1936* s 82SA.

Rent

[31.4.1060] Ordinarily rental payments made to obtain the right to occupy premises used for the purpose of earning assessable income are deductible.[1] However, the fact that an outgoing is described as rent does not determine its character. Rental payments are ordinarily recurrent, and ordinarily they bear a relationship to the income expected to be earned by virtue of that occupation during the relevant accounting period. Where those features are absent the court sets aside nomenclature and examines the substance of the transaction and, where relevant, the purpose for which it was undertaken.[2]

In *Commissioner of Taxation v Creer* (1986) 11 FCR 52; 17 ATR 548 a taxpayer made significant prepayments of rent under the terms of a lease which enabled his family company to acquire the freehold (reversion) of the property discounted to allow for the loss of the right to receive future rent as a result of the substantial prepayment of rent. The Full Federal Court held that the prepayment of rent was a capitalised sum payable by instalments rather than rent accruing from day to day relating to the use of the premises for the derivation of assessable income.[3]

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1 *Commissioner of Taxation v Creer* (1986) 11 FCR 52; 17 ATR 548 (FC).

2 *Commissioner of Taxation v Creer* (1986) 11 FCR 52; 17 ATR 548 (FC), 60–61 (Wilcox J) (FCR).

3 *Commissioner of Taxation v Creer* (1986) 11 FCR 52; 17 ATR 548 (FC), 57–58 (Fisher J) (FCR), Wilcox and Jackson JJ agreeing.

[31.4.1070] In order to be deductible an outgoing of rent must be relevant to the production of assessable income. The relevance of rent to the production of assessable income is determined by reference to the use made of the property in respect of which the rent is paid. Therefore, rent paid for business premises is usually deductible. However, if premises are used partly for business purposes and partly for private purposes then it may be necessary to apportion the rent between deductible and non-deductible components.

The same principle applies to rent paid for the use of chattels. In *Commissioner of Taxation v EA Marr & Sons (Sales) Ltd* (1984) 2 FCR 326; 15 ATR 879 the taxpayer incurred rent for the hiring of plant and equipment which the taxpayer allowed its subsidiary companies to use in the conduct of their business operations. The Full Federal Court held that the taxpayer was allowed a deduction as the taxpayer was allowing the subsidiary companies to trade and be successful so as to derive dividends from them which would constitute assessable income of the taxpayer.

[31.4.1080] In order to be deductible, rent must have a working character. Rent is not deductible if it is capital in nature. A payment made under a lease may be of a capital nature if it is in truth a payment towards the purchase price of the premises or chattels subject to the lease.[1] This issue has been particularly important in relation to leases of plant and equipment. Under a finance lease, the lessee may acquire the item subject to a lease for a predetermined price ("the residual value") on termination. The Commissioner of Taxation requires that the residual value equate to the fair market value of the asset at the end of the lease.[2] The Commissioner has published a table of residual values which is intended to serve as a rough guide of minimum market values.[3]

The absence of an arm's length relationship between a landlord and tenant can quite often raise a question as to the true purpose for which rent was paid. A non-arm's length relationship suggests a non-commercial purpose for the transaction and accordingly an uncommercial consideration. If this is the case then the outgoing either lacks the requisite character of relevance and incidence or it is excluded as being private in nature.

Where plant or equipment is leased under a hire-purchase agreement it is the Commissioner's practice to allow the hirer to deduct the interest and borrowing cost component of the hire-purchase charges under s 8-1 of the *Income Tax Assessment Act 1997* (Cth) in the year in which they are incurred and may also claim depreciation based on the initial cost of the asset.[4]

Part 3-10 Div 242 of the *Income Tax Assessment Act 1997* (Cth) provides that lease arrangements of "luxury" cars[5] will be treated as sale and loan transactions. The lessor will be treated as having lent the purchase price to the lessee to acquire the car. The lessor is to be taxed on the interest component of the lease payments while the lessee is entitled to deduct the notional interest component of the lease payments only.

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1 *Commissioner of Taxation v Creer* (1986) 11 FCR 52; 17 ATR 548 (FC); *Federal Commissioner of Taxation v Ballarat & Western Victoria TV Ltd* (1978) 45 FLR 218; 9 ATR 274 (VSC); but see *Federal Commissioner of Taxation v South Australian Battery Makers Pty Ltd* (1978) 140 CLR 645; 52 ALJR 640; 8 ATR 879.

2 See Australian Taxation Office, *Leasing Arrangements of Plant and Machinery*, IT 28, 6 July 1960.

3 See Australian Taxation Office, *Leasing Arrangements of Plant and Machinery*, IT 28, 6 July 1960. See also Australian Taxation Office, *Income Tax: Deductions for Lease Shortfall Payments*, IT 2287, 11 April 1986; Australian Taxation Office, *Income Tax: In Calculating the Residual Value of a Leased Item, May a Lower Residual Value than those Outlined in IT 28 be Adopted in Light of the More Generous Depreciation Rates?*, TD 93/142, 22 July 1993.

4 See Australian Taxation Office, *Income Tax: Division 240: Deductibility of 'Notional Interest' to the Notional Buyer under a Hire Purchase Agreement*, ATO ID 2003/1197, 22 December 2003, which states that the taxpayer, as the notional buyer under the hire purchase agreement, is entitled to deduct "notional interest" for an income year to the extent that the taxpayer would, apart from *Income Tax Assessment Act 1997* (Cth) Div 240, have been entitled to deduct "arrangement payments" for that income year if no part of those payments were capital in nature. The hirer is considered to be the owner of the property for capital allowances purposes if it is reasonable to conclude that the hirer will acquire the asset, or that the asset will be disposed of at the direction and for the benefit of the hirer: see Australian Taxation Office, *Income Tax: The Interaction of Deemed Ownership under Division 240 of the Income Tax Assessment Act 1997 with the "Holding" Rules in Division 40*, TR 2005/20, 14 December 2005.

5 "Luxury cars" are motor vehicles which cost more than the capital allowance cost limit in *Income Tax Assessment Act 1997* (Cth) s 40-230: see [31.4.1480]. The car limit for the 2016–2017 financial year is $57,581: see Australian Taxation Office, *Income Tax: What is the Car Limit under Section 40-230 of the Income Tax Assessment Act 1997 for the 2016-17 Financial Year?*, TD 2016/8, 8 June 2016. See also *Luxury Car Tax Determination LCTD 2016/1*, which sets the luxury car tax threshold for 2016–2017 at $64,132.

[31.4.1090] A number of anti-avoidance provisions may affect the deductibility of payments under a lease. "Leveraged" leases are the subject of anti-avoidance provisions contained in former s 51AD and Pt III Div 16D of the *Income Tax Assessment Act 1936* (Cth) and current Pt 3-10 Div 250 of the *Income Tax Assessment Act 1997* (Cth). Anti-avoidance provisions in s 82KJ and s 82KL may also apply to lease payments.

Rent on income producing property and on plant and equipment used to gain or earn assessable income, or in the conduct of a business for that purpose, is one kind of recurrent expenditure made to secure capital or working capital which has the essential character of being on revenue account and hence deductible.[1] By analogy to the treatment of interest by the High Court in *Steele v Deputy Commissioner of Taxation* (1999) 197 CLR 459; 73 ALJR 437; 41 ATR 139; [1999] HCA 7, rent does not ordinarily secure an enduring or structural advantage so that, accordingly, it is proper to regard rent as a revenue item.[2]

1 *Texas Co (A'asia) Ltd v Federal Commissioner of Taxation* (1940) 63 CLR 382; 5 ATD 298, Dixon J at 468 (CLR).
2 *Steele v Deputy Commissioner of Taxation* (1999) 197 CLR 459; 73 ALJR 437; 41 ATR 139; [1999] HCA 7.

Repairs and Maintenance

[31.4.1100] In order to be deductible an outgoing for repairs or maintenance must be relevant to the derivation of assessable income or to the conduct of a business for that purpose. If so then the repair and maintenance expenses are deductible under s 8-1 of the *Income Tax Assessment Act 1997* (Cth).[1] Where repair and maintenance expenses have been used to "maintain" property or plant and equipment which is used to gain or earn assessable income or to conduct a business for that purpose, then they have the requisite working character. However, where repair and maintenance expenses involve some "improvement" in the character of the underlying property or plant and equipment as an asset of the taxpayer, then they are capital. A common example is "repairs" made to a newly purchased investment property will typically be considered capital in nature on the basis that it is improving the property, whereas repairs made subsequently (such as after a tenant has moved in) will be deductible provided those repairs are not improvements.

1 See *Federal Commissioner of Taxation v Western Suburbs Cinemas Ltd* (1952) 86 CLR 102; 9 ATD 452, 105–106 (Kitto J): see [31.4.1120].

[31.4.1110] Section 25-10 of the *Income Tax Assessment Act 1997* (Cth) provides an express deduction for expenditure incurred by a taxpayer for repairs. Section 25-10 allows a deduction for repairs which are not of a capital nature to any premises, or part of premises, or depreciating assets held or used by the taxpayer for the sole purpose of producing assessable income. Section 25-10(2) entitles the taxpayer to a deduction for only so much of that expenditure as is reasonable in the circumstances. The Australian Taxation Office view, in accordance with *Taxation Ruling TR 97/23*, is that this generally requires an apportionment based on the proportion of use for income-producing purposes.[1]

The test of deductibility in s 25-10 is use or holding of the property "for the purpose of producing assessable income" so that the purpose is the overriding criterion of deductibility in s 25-10.

1 Australian Taxation Office, *Income Tax: Deductions for Repairs*, TR 97/23, 3 December 1997, [79], [151]–[161].

[31.4.1120] Repairs are not deductible to the extent that they are capital in nature. The most common issue in relation to repairs and maintenance expenses is whether they are capital in nature. Expenditure to effect an improvement to an asset is capital in nature, even if the asset requires repair. A repair is generally the renewal or replacement of defective parts, which can be distinguished from an improvement, renewal or replacement of substantially the whole.[1] The leading decision in this respect is *Federal Commissioner of Taxation v Western Suburbs Cinemas Ltd* (1952) 86 CLR 102; 9 ATD 452 (CLR), which involved replacement of a ceiling of a cinema with a new and improved ceiling. The Court declined to allow a deduction on the basis that the repairs did more than restore the original ceiling, they provided an improved ceiling.[2] The Court also denied a deduction under former s 53 of the *Income Tax Assessment Act 1936* (Cth) (replaced by s 25-10 of the *Income Tax Assessment Act 1997* (Cth)) of a notional lesser amount for the estimated cost of repairs to the old ceiling if they had been carried out.[3]

There is nothing in *Federal Commissioner of Taxation v Western Suburbs Cinemas Ltd* to suggest that a claim for a deduction is excluded merely because a repair is effected using materials which are different from those originally used to construct the underlying property. Nor is it fatal to a deduction entitlement if some degree of improvement is effected as a result of using more modern materials.[4]

Expenditure which is in truth incurred in the purchase of a new asset is of a capital nature. The test applied by the courts is to ask whether the expense is incurred in the restoration of a part of the underlying property or whether it amounts to a reconstruction of the entire asset or substantially the whole of the asset.[5] Where the expense is truly of the latter type then an apportionment of the expense is not possible because the entire expense lacks the requisite working character.[6] This issue was considered in *Lindsay v Federal Commissioner of Taxation* (1961) 106 CLR 377; 35 ALJR 407; 12 ATD 505[7] which involved the reconstruction of one of a number of slipways of the taxpayer, a ship builder. The entire outgoing was non-deductible as the slipway was considered to be the entirety.

Repairs which are necessary at the time of purchase of an income-producing asset are also regarded as being capital in nature.[8] Such expenditure is to be added to the purchase price of the asset and may be depreciable if the underlying asset is depreciable.

1 *Lurcott v Wakely & Wheeler* (1911) 1 KB 905 (CA), 924 (Buckley LJ).

2 *Federal Commissioner of Taxation v Western Suburbs Cinemas Ltd* (1952) 86 CLR 102; 9 ATD 452, 106–107 (Kitto J) (CLR).

3 *Federal Commissioner of Taxation v Western Suburbs Cinemas Ltd* (1952) 86 CLR 102; 9 ATD 452, 108–109 (Kitto J) (CLR).

4 See *Morcom v Campbell-Johnson* [1956] 1 QB 106; [1955] 3 WLR 497 (CA), 114–115 (Denning LJ) (QB).

5 *Lurcott v Wakely & Wheeler* [1911] 1 KB 905 (CA), 923–924 (Buckley LJ).

6 *W Thomas & Co Pty Ltd v Federal Commissioner of Taxation* (1965) 115 CLR 58; 39 ALJR 246; 14 ATD 78, 72 (Windeyer J) (CLR).
7 See also *O'Grady v Bulcroft Main Collieries Ltd* (1932) 17 TC 93; *Rhodesia Railways Ltd v Income Tax Collector (Bechuanaland)* [1933] AC 368 (PC).
8 *Law Shipping Co Ltd v Commissioners of Inland Revenue (UK)* [1924] SC 74.

[31.4.1130] An outgoing incurred for non-compliance with an obligation to repair contained in a lease may be deductible. Section 25-15 of the *Income Tax Assessment Act 1997* (Cth) gives a deduction for a payment that a taxpayer is obliged to pay to a landlord for failing to comply with a lease obligation to make repairs to the leased premises. Such a payment for non-compliance with a covenant to repair gives to the taxpayer precisely the same deduction that the taxpayer would otherwise have been entitled to under either s 25-10 or s 8-1 (as the case may be) for actually repairing the leasehold premises in compliance with the lease obligation. The amount paid is a deduction in the year in which it is paid.[1]

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1 *Peyton v Federal Commissioner of Taxation* (1963) 109 CLR 315; 37 ALJR 149; 13 ATD 133.

Royalties and Licence Fees

[31.4.1140] Royalties incurred in gaining or producing assessable income which are revenue in nature are tax deductible. The term "royalties" is defined in s 6(1) of the *Income Tax Assessment Act 1936* (Cth).[1] The definition is inclusive and incorporates general law concepts of royalties.[2] Nevertheless, there is no statutory provision which makes royalties deductible. In order to be deductible royalties must satisfy the requirements of s 8-1 of the *Income Tax Assessment Act 1997* (Cth). It is an error to try to characterise royalties as an outgoing by reference to the character of the royalties in the hands of the recipient. Outgoings are to be characterised as a deduction exclusively from the viewpoint of the taxpayer paying them and without regard to the treatment of the royalties in the hands of the recipient.[3] Generally, royalties should be deductible if they are a payment for the use of the property as distinct from the right to use the property.[4]

Quite often the form of the contractual obligation to pay royalties or payments under a licence can affect the deductibility of the outgoing. In *McCauley v Federal Commissioner of Taxation* (1944) 69 CLR 235; 7 ATD 427 (a case concerned with the assessability of royalty receipts) the obligation to pay royalties was dependent upon the actual taking of timber rather than being an obligation that was unrelated to use. The payments were therefore characterised as revenue in nature from the taxpayer recipient's perspective. It is likely that they would also be revenue in nature to the payer of the royalty for whom the royalty is an outgoing, but the characterisation in the recipient's hands is not conclusive of the characterisation in the payer's hands.[5] Where the obligation to pay the royalty is referable to the quantity of the thing used or taken the royalty or licence fee outgoings should have a working character.[6]

It should be noted that, notwithstanding the above, royalties may nonetheless not be deductible if royalty withholding tax (where applicable) has not been withheld and remitted to the Australian Tax Office.[7]

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1 *Income Tax Assessment Act 1997* (Cth) s 995-1.
2 The meaning of royalty at common law is considered in “Royalties and Like Payments” [31.3.890]–[31.3.1030].
3 This certainly was the approach of the Privy Council in *BP Australia Ltd v Federal Commissioner of Taxation* [1966] AC 224; [1965] 3 WLR 608; (1965) 112 CLR 386; 39 ALJR 190; 14 ATD 1 and *Cliffs International Inc v Federal Commissioner of Taxation* (1979) 142 CLR 140; 53 ALJR 321; 9 ATR 507.
4 *Cliffs International Inc v Federal Commissioner of Taxation* (1979) 142 CLR 140; 53 ALJR 321; 9 ATR 507. See also RW Parsons, *Income Taxation in Australia: Principles of Income, Deductibility and Tax Accounting* (Law Book Co, 1985) [6.203].
5 This certainly was the approach of the Privy Council in *BP Australia Ltd v Federal Commissioner of Taxation* [1966] AC 224; [1965] 3 WLR 608; (1965) 112 CLR 386; 39 ALJR 190; 14 ATD 1; *Cliffs International Inc v Federal Commissioner of Taxation* (1979) 142 CLR 140; 53 ALJR 321; 9 ATR 507.
6 *Federal Commissioner of Taxation v Sherritt Gordon Mines Ltd* (1977) 137 CLR 612; 51 ALJR 772; 7 ATR 726, in particular, 617 (Mason J) (CLR).
7 *Income Tax Assessment Act 1997* (Cth) s 26-25.

[31.4.1150] A payment made for a non-exclusive right or licence to use the industrial or intellectual property of another should ordinarily be revenue in nature.[1] This is the normal rule because such a payment is for the use of the property rather than for the acquisition of the property. However, a single payment for a non-exclusive licence may not be deductible, depending on the term of the licence and the nature of the rights conferred under the licence, because it has given the taxpayer a lasting advantage: namely, use of the property for the term of the licence. Such a payment may be capital in nature.

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1 *Cliffs International Inc v Federal Commissioner of Taxation* (1979) 142 CLR 140; 53 ALJR 321; 9 ATR 507.

[31.4.1160] A payment made for the exclusive right or licence to use the industrial or intellectual property of another is likely not to be deductible on the basis that it is for the right to use the property. The obtaining of an exclusive right or licence to use industrial or intellectual property is regarded as tantamount to the acquisition of the item of intellectual property itself as the owner of it is precluded from licensing its use to anyone else.[1] A similar treatment is accorded payments for the non-exclusive use of know-how under s 8-1 of the *Income Tax Assessment Act 1997* (Cth) as applies in the case of industrial and intellectual property, and a similar denial of a deduction occurs in the case of exclusive rights or licences of know-how under s 8-1 of the *Income Tax Assessment Act 1997*.[2]

Where the exercise of a licence which gives rise to a deductible payment relates to raw materials or trading stock in the taxpayer’s hands, then the taxpayer may be obliged to also account for the product of the exercise of the licence under the separate trading stock provisions:[3] see [31.4.1250].

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1 *Commissioners of Inland Revenue (UK) v British Salmson Aero Engines Ltd* [1938] 2 KB 4823 (CA). This case concerned the character of a payment received by the grantor of a licence; however, the principles applied are equally applicable to the characterisation of a payment in the hands of a payer.
2 *Cliffs International Inc v Federal Commissioner of Taxation* (1979) 142 CLR 140; 53 ALJR 321; 9 ATR 507.
3 *Cliffs International Inc v Federal Commissioner of Taxation* (1979) 142 CLR 140; 53 ALJR 321; 9 ATR 507.

[31.4.1170] Where royalties or payments under a licence for the use of intellectual property are capital in nature they may be amortised over the life of the income-producing asset to which they relate. It may be possible to amortise royalties which are capital in nature under Pt 2-10 Div 40 Subdiv 40-I of the *Income Tax Assessment Act 1997* (Cth) (relating to project pools), Pt 2-10 Div 40 Subdiv 40-B (capital allowances regime relating to patents, registered designs and copyrights) and s 70-120 (relating to royalties for the felling of trees on land). These provisions give a less favourable outcome than s 8-1 of the *Income Tax Assessment Act 1997*, which allows a full deduction in the year the outgoing is incurred (for post-1 July royalty payments).

Bad Debts

[31.4.1180] A bad debt written off in the accounts of a business may be deductible under either ss 8-1 or 25-35 of the *Income Tax Assessment Act 1997* (Cth). Although s 25-35 of the *Income Tax Assessment Act 1997* is a specific provision relating to bad debts the section does not cover the field so as to exclude the operation of s 8-1. Section 25-35 is concerned only with the writing off of a bad debt in the books of account of the taxpayer whereas s 8-1 provides a broader basis for a deduction. In addition to the situation where a trading debt is written off in the taxpayer's books, s 8-1 may allow a deduction where a debt is disposed of by the taxpayer at a loss.[1]

The requirements for a deduction under s 25-35 of the *Income Tax Assessment Act 1997* are threefold:

(1) The debt must be "bad". This does not require that it is legally impossible to recover, it merely requires that the creditor has concluded bona fide that it is bad in the circumstances.

(2) The debt must be written off as bad during the year of income. It is not sufficient if the debt was written off after the end of the year of income as part of the balance day adjustments; however, it is sufficient if there are written particulars indicating that the creditor has treated the debt as bad during the year of income.[2] The debt must be written off before it is compromised. Otherwise there is no debt in existence at the time of the write off.[3]

(3) The debt must have been brought to account by the taxpayer as assessable income in any year or it must be in respect of money lent in the ordinary course of a business of the lending of money by a taxpayer who carries on that business.[4]

Section 25-35 not only deals with the deductibility of bad debts incurred by the taxpayer but also with the deductibility of bad debts where the debt has been purchased by the taxpayer.

A bad debt is revenue in nature for the purposes of s 8-1 if it relates to a trading receipt which has been included in assessable income or if it relates to a loan made by a taxpayer who is a money lender in the ordinary course of the taxpayer's business.[5] There may also be further circumstances where a debt is on revenue account under s 8-1. For example, in *Commissioner of Taxation v Marshall & Brougham Pty Ltd* (1987) 17 FCR 541; 18 ATR 859, the Full Federal Court denied a deduction under s 63 of the *Income Tax Assessment Act 1936* (the predecessor of s 25-35 of the *Income Tax Assessment Act 1997*) for money on deposit with a lending institution which collapsed, but allowed the deduction under the general deduction provision. The taxpayer was carrying on the business of construction manager which involved the regular placing of surplus funds on short-term interest-bearing deposit. The deduction was allowed by the majority of the Court on the basis that the loss was incurred as an incident of the taxpayer's ordinary business activities.

Bad debts are deductible under s 8-1 of the *Income Tax Assessment Act 1997* (Cth) even though the taxpayer has ceased to carry on the business which gave rise to the debts. In *AGC (Advances) Ltd v Federal Commissioner of Taxation* (1975) 132 CLR 175; 49 ALJR 105; 5 ATR 243, the taxpayer was a financier which had its business activities suspended in 1968. It resumed its finance business in 1970 following the entering into of a scheme of arrangement and sale of the company to a new group. There were debts owing to the taxpayer in respect of money lent and hire-purchase contracts which the taxpayer entered into as a financier. The hiring charges of the hire-purchase contracts had been brought to account by the taxpayer as assessable income. The taxpayer wrote amounts off as bad debts in the years ended 30 June 1970 and 1971 in respect of the hiring charges, the other parts of the instalments due under the hire-purchase agreements and debts for money lent. It claimed that these amounts were deductible under s 63 and former s 51 of the *Income Tax Assessment Act 1936* (see now ss 25-35 and 8-1 of the *Income Tax Assessment Act 1997* respectively). Barwick CJ and Mason J found that the debts were deductible.[6] Both judges took the view that the company carried on the same business after the termination of the scheme of arrangement as it did before. Mason J (Barwick CJ concurred) also took the view that a loss is incurred under the second limb of the general deduction provision even after a business has terminated if the occasion for the loss is to be found in a transaction entered into in the carrying on of the business for the purpose of producing assessable income.[7]

Section 20-20 of the *Income Tax Assessment Act 1997* provides that an amount you receive as recoupment of a loss or outgoing, except by way of insurance or indemnity, is an assessable recoupment if it is deductible as a loss or outgoing for the current year, or if you have deducted or can deduct an amount for the loss or outgoing for an earlier year of income under a provision listed in s 20-30. Section 20-25 provides that a recoupment of a loss or outgoing includes any kind of recoupment reimbursement refund insurance indemnity or recovery however described and a grant in respect of the loss or outgoing.

Section 20-30 then provides a table of deductions under the *Income Tax Assessment Act 1997* for which recoupments are assessable. Section 20-30(1) Table Item 1.1 provides that a recoupment of an expense being a bad debt is a recoupment which is assessable under the *Income Tax Assessment Act 1997*. Accordingly, by virtue of s 20-30 a bad debt which has been written off and which has been made the subject of a deduction either in the current year of income or an earlier year of income under s 8-1 will become an assessable recoupment and as such assessable income by virtue of s 20-30.

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1 In *Fairway Estates Pty Ltd v Federal Commissioner of Taxation* (1970) 123 CLR 153; 44 ALJR 306; 1 ATR 726, 162 (Barwick CJ) (CLR) held that a deduction was available under former *Income Tax Assessment Act 1936* (Cth) s 51(1) (predecessor to *Income Tax Assessment Act 1997* (Cth) s 8-1) in an appropriate case for an irrecoverable debt once recognised as such in the taxpayer's books of account. This approach has since been adopted by the Commissioner of Taxation as an appropriate basis for a deduction under s 8-1 in Australian Taxation Office, *Income Tax: Bad Debts*, TR 92/18, 17 December 1992. The Commissioner is currently reviewing *Taxation Ruling TR 92/18* as a result of the recent case of *Federal Commissioner of Taxation v BHP Billiton Finance Limited* (2010) 182 FCR 526; 76 ATR 472; [2010] FCAFC 25, which held that a deduction is available under s 8-1 for bad debt incurred by a related financial company.

2 *Case 33* (1941) 10 CTBR 101.

3 *Point v Federal Commissioner of Taxation* (1970) 119 CLR 453; 44 ALJR 121; 1 ATR 577; *Franklin's Selfserve Pty Ltd v Federal Commissioner of Taxation* (1970) 125 CLR 52; 44 ALJR 346; 1 ATR 673.

4 Former *Income Tax Assessment Act 1936* (Cth) s 63, the predecessor to *Income Tax Assessment Act 1997* (Cth) s 25-35, was examined by the High Court in *Fairway Estates Pty Ltd v Federal Commissioner of Taxation* (1970) 123 CLR 153; 44 ALJR 306; 1 ATR 726. In relation to the question whether a company that lends within a corporate group can be said to be in the business of money-lending, see *Federal Commissioner of Taxation v Bivona Pty Ltd* (1989) 20 ATR 282 (FCA); *Richard Walter Pty Ltd v Federal Commissioner of Taxation* (1996) 34 ATR 467 (FCA).

5 That is, if the debt satisfies the requirements of *Income Tax Assessment Act 1997* (Cth) s 25-35.

6 *AGC (Advances) Ltd v Federal Commissioner of Taxation* (1975) 132 CLR 175; 49 ALJR 105; 5 ATR 243, 184–188 (Barwick CJ), 197–198 (Mason J) (CLR).

7 *AGC (Advances) Ltd v Federal Commissioner of Taxation* (1975) 132 CLR 175; 49 ALJR 105; 5 ATR 243, 184–188 (Barwick CJ), 197–198 (Mason J) (CLR).

[31.4.1190] A number of anti-avoidance provisions limit the availability of deductions for bad debts. Part 3-5 Div 165 Subdivs 165-C and 166-C of the *Income Tax Assessment Act 1997* (Cth) require a company to satisfy a "continuity of shareholding test" or a "same business test" as a further requirement for a deduction under ss 8-1 or 25-35.

Part 3-5 Div 165 Subdiv 165-C provides that a company cannot deduct a bad debt unless, where the debt was incurred in an earlier year of income, the company had the same owners and the same control during the rest of that income year and also during the income year in which it writes off the debt as bad; or where the debt was incurred in the current year of income, the company had the same owners and the same control during the income year both before and after the debt was incurred; or if there has been a change in ownership or control, the company has since carried on the same business, entered no new kinds of transactions and conducted no new kinds of business since the debt was incurred.[1] Also, a company cannot claim a deduction in respect of a bad debt written off on the last day of the year of income if the debt was also incurred on that day.[2]

Further, ss 63E and 63F of the *Income Tax Assessment Act 1936* (Cth) govern the availability of deductions arising from "debt/equity" swaps. A "debt/equity swap" is, broadly speaking, the extinguishment of a debt in return for the issue to the creditor of equity in the debtor entity.

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1 See "Companies and Shareholders" [31.9.10]ff.
2 *Income Tax Assessment Act 1997* (Cth) s 165-120(3).

Insurance Premiums

[31.4.1200] The deductibility of insurance premiums is dependent upon the purpose of the insurance. Before one can properly characterise an insurance premium under s 8-1 of the *Income Tax Assessment Act 1997* (Cth) one needs to know the true nature of the receipt which the insurance policy ultimately generates if a claim upon it is made. A receipt of insurance proceeds is income in nature if it is a substitute for an item of income. The premiums for insurance, the proceeds of which are assessable income, would ordinarily be tax deductible.

However, not all premium payments which generate an income receipt are deductible and not all premium payments which generate a capital receipt on making a claim on the policy are denied deductibility under s 8-1. Above all else, the purpose of the premium payment determines the relevance and working character of the outgoing to the insurance proceeds produced or to the conduct of a business of which the policy forms an asset.

An insurance premium may clearly demonstrate a direct relationship to the derivation of assessable income in the form of policy proceeds but it may be deprived of a working character by being a one-off premium for the life of the policy, which generates a long term benefit for the taxpayer or the business of the taxpayer which owns the policy,[1] just as the prepayment of interest[2] or rent[3] is not deductible if it gives a lasting advantage to the taxpayer.[4]

An insurance premium is also not deductible if the premium was paid not to maintain the business against the cost of an outgoing, but to ensure that there would be funds to meet that outgoing.[5] This proposition is illustrated by the decision in *Ransburg Australia Pty Ltd v Federal Commissioner of Taxation* (1980) 47 FLR 177; 10 ATR 663. The funds were applied for the purpose of making provision in the taxpayer's accounts of funds to meet future long service leave payments which were expected to arise in the normal course of the taxpayer's business in future years of income. The taxpayer was denied a deduction for the long service leave provisions because no outgoing for long service leave had been "incurred" in the sense of being paid to employees.

On the other hand, the courts have no difficulty in accepting as deductible an insurance premium designed to maintain the business against the cost of meeting an outgoing where the event causing the outgoing is a misfortune which arises outside the normal course of business. An example of this kind of outgoing was the premiums paid in *Carapark Holdings Ltd v Federal Commissioner of Taxation* (1967) 115 CLR 653; 40 ALJR 506; 14 ATD 402 (a case concerned with the assessibility of proceeds received from an insurance policy).

In *Carapark Holdings Ltd v Federal Commissioner of Taxation* the premium was incurred in order to insure against the death by air accident of an employee of the taxpayer or of one of its subsidiaries. The proceeds from the policy were held to be assessable and it appears that the

Commissioner of Taxation had allowed deductions for the premiums in the years they were paid.[6] The expenses insured against clearly were not ordinary expenses of the conduct of the taxpayer's business; rather they were extraordinary expenses. Likewise, premiums for insurance to protect against the loss of property and/or income due to fire or accident are deductible, notwithstanding that the expenditure flowing from the loss will, if it arises, be on capital account.

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1 An example of such a policy is the self-funding "key man" or "key person" policies sold to Australian business people throughout the 1980s and early 1990s by Australian life offices, where a one-off premium was said to generate enough premium income (in the form of interest or bonuses) to fund the premium payment obligations on the policy for the life of the policy. See Australian Taxation Office, *Key Man Insurance – Assessability of Proceeds and Deductibility of Premiums*, IT 155, 28 June 1968, for the Commissioner of Taxation's views on this.

2 *Federal Commissioner of Taxation v Ilbery* (1981) 58 FLR 191; 12 ATR 563 (FCAFC).

3 *Federal Commissioner of Taxation v Creer* (1986) 11 FCR 52; 17 ATR 548 (FC).

4 *Sun Newspapers Ltd v Federal Commissioner of Taxation* (1938) 61 CLR 337; 12 ALJR 411; 5 ATD 87.

5 See also RW Parsons, *Income Taxation in Australia: Principles of Income, Deductibility and Tax Accounting* (Law Book Co, 1985) [6.212]. For a case which may be inconsistent with this proposition, see *Australian National Hotels Ltd v Commissioner of Taxation* (1988) 19 FCR 234; 19 ATR 1575 (FC), in which premiums paid by a taxpayer to insure against foreign exchange losses on repayment of a loan on capital account were held to be deductible under former *Income Tax Assessment Act 1936* (Cth) s 51.

6 *Carapark Holdings Ltd v Federal Commissioner of Taxation* (1967) 115 CLR 653; 40 ALJR 506; 14 ATD 402.

[31.4.1210] A premium for a policy of insurance, the proceeds of which is the payment of an annuity, is not deductible. The reason for its not being deductible is that the proceeds (the annuity) is both an item of capital[1] and an item of income,[2] there being no apportionment of the premium permissible for the purposes of s 8-1 of the *Income Tax Assessment Act 1997* (Cth). This is because, as a matter of ordinary concepts, an annuity is an affair of capital, and because that part of the premium which does relate to the capital component is subtractable under s 27H of the *Income Tax Assessment Act 1936* (Cth) in ascertaining the undeducted purchase price of the policy. However, if the policy provides compensation for a loss of assessable income of the taxpayer or of a business being conducted by the taxpayer then the premium is deductible as it does in that event satisfy the dual tests of relevance and incidence to the derivation of that assessable compensation income. This is exactly the situation that occurred in *Federal Commissioner of Taxation v Smith* (1981) 147 CLR 578; 55 ALJR 229; 11 ATR 538 where the taxpayer, a medical practitioner, returned as assessable income the proceeds of a sickness and accident policy while he was unable to practise his profession and succeeded in his claim for a deduction under the then s 8-1 for the premiums he had paid under the policy. Tracing helps to establish the relevance of a premium which is said to generate an assessable compensation receipt under the policy, but it does not assist in ascertaining the working character of the expense because the characterisation of the policy proceeds as a capital receipt and does not necessarily defeat the characterisation of the premium as being working in nature:[3] see [31.4.1200].

1 *Secretary of State in Council of India v Scoble* [1903] AC 299, although now only the "deductible amount", in effect the capital cost or undeducted purchase price of the annuity spread over its life, is a capital amount under *Income Tax Assessment Act 1936* (Cth) s 27H(1).
2 *Income Tax Assessment Act 1936* (Cth) s 27H, excluding the deductible amount.
3 Tracing is an exercise involving the ascertainment of an individual fund of money through various accounts and transactions. There is a useful description of tracing made by Hill J in *Kidston Goldmines Ltd v Commissioner of Taxation* (1991) 30 FCR 77; 22 ATR 168: see [31.4.970].

[31.4.1220] A premium paid under a policy insuring the loss of an individual's earning capacity resulting from physical injury is not deductible to a taxpayer who is the beneficiary under the policy. The premium is not deductible because it is not relevant to the derivation of assessable income and the proceeds are capital in nature. It is also not deductible because earning capacity, as distinct from the earnings themselves, is a purely personal matter. However, the premiums paid by employers to meet the cost of compensating employees injured at work are deductible. An example of the latter type of payment is the premium on a workers' compensation policy which results in a lump sum workers' compensation payment or lump sum common law damages for negligence to an employee of the taxpayer for bodily or emotional injury to an employee. A similar result applies in the case of occupier's liability insurance and public liability insurance but only where the insurance relates to business premises of the taxpayer.

[31.4.1230] A premium paid for annual cover under a policy insuring against damage by fire or accident to property is deductible if the property insured is used exclusively for the production of assessable income or for the conduct of a business for that purpose. Where the property insured is only partly used for the production of assessable income or for the conduct of a business for that purpose, then the taxpayer needs to apportion the premium between its income and non-income purposes, using as the basis of the apportionment the proportion of the use of the property for the income-producing purpose as compared with the proportion of the use of the property for all other purposes during the year of income. The result that the policy proceeds are not income does not deprive the premium of its character as being relevant and working in nature, a further example of the deductibility of a premium where there is no correlation between the character of the receipt on income account and the character of the premium: see [31.4.1220]. Insurance premiums which are paid to provide cover against other risks may also be deductible.[1]

1 *Australian National Hotels Ltd v Commissioner of Taxation* (1988) 19 FCR 234; 19 ATR 1575 (FC).

[31.4.1240] Premiums on a policy insuring the life of a person other than the insured may be deductible where the death of the insured would have detrimental consequences to the conduct of a business.[1] However, a premium paid by a taxpayer for insurance on her or his own life is not ordinarily deductible as being an affair of capital. Where A insures against loss suffered by A as a result of bodily injury suffered to B (B need not be an employee of A but could be anyone whose inability to work would detrimentally affect the conduct of A's business), then the premium on the policy is deductible where the losses insured against are (if suffered) or would have been (but for immediate reimbursement by the insurer) deductible under s 8-1 of the *Income Tax Assessment Act 1997* (Cth).[2] The mere fact that the policy proceeds are a lump sum does not deprive the premium of its deductibility. The policy proceeds in *Carapark Holdings Ltd v Federal Commissioner of Taxation* (1967) 115 CLR 653; 40 ALJR 506; 14 ATD 402 were received as a lump sum yet the Commissioner of Taxation treated the premium as deductible: see [31.4.1200].

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1 This is for the reasons given in *Carapark Holdings Ltd v Federal Commissioner of Taxation* (1967) 115 CLR 653; 40 ALJR 506; 14 ATD 402. The Commissioner accepts this principle: see Australian Taxation Office, *Key Man Insurance – Assessability of Proceeds and Deductibility of Premiums*, IT 155, 28 June 1968. In Australian Taxation Office, *Income Tax: Split Dollar Insurance Arrangements*, IT 2434, 16 July 1987, the Commissioner states that premiums paid by an employer under a "split dollar" arrangement may be deductible to the employer. A split dollar arrangement arises where two parties (usually an employer and employee) agree that each owns one of the two components of a life assurance policy. Usually the employer owns and is entitled to the benefits of the term component of the policy while the employee owns and is entitled to the investment component of the policy. The term component must be taken out for a revenue purpose in order for the employer's share of the premium to be deductible. Split dollar arrangements may be contrasted with "split purpose" arrangements. Under a split purpose arrangement the employer is the sole owner of a permanent life assurance policy. There is no legal division of the benefit entitlements under the policy as there is under a split dollar arrangement. The premiums are therefore treated as non-deductible.

2 A good example of a deductible premium for insuring against a non-employee loss is the premium paid for insurance against the cost of legal fees thrown away from the untimely incapacitation or death of a judge hearing a long set of proceedings in which the taxpayer is a party, resulting in a completely new trial of the proceedings, using, among other things, the principles discussed by the Full Federal Court in *Magna Alloys & Research Pty Ltd v Federal Commissioner of Taxation* (1980) 49 FLR 183; 11 ATR 276.

Trading Stock and Raw Materials

[31.4.1250] Expenditure incurred in acquiring trading stock and raw materials is tax deductible. Costs associated with the acquisition of trading stock are deductible pursuant to s 8-1 of the *Income Tax Assessment Act 1997* (Cth).

The *Income Tax Assessment Act 1997* contains comprehensive provisions governing the deductibility and assessability of movements in the value of trading stock on hand.[1]

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1 See "Trading Stock" [31.5.650]–[31.5.1260].

Rates and Taxes

[31.4.1260] The tax deductibility of rates and property taxes is determined by reference to the purpose for which the taxpayer acquired or currently uses the property in respect of which the outgoing was incurred. If the underlying property on which the rates or taxes are chargeable is used wholly to derive assessable income or is used in the conduct of a business for that purpose then the rates and taxes are deductible under s 8-1 of the *Income Tax Assessment Act 1997* (Cth). Where there is only a partial use of the property for that purpose then an apportionment is called for in ascertaining the deductibility of the rates or taxes.

[31.4.1270] A reimbursement of rates or taxes previously claimed as a deduction is assessable income. Where a taxpayer has received a recoupment of rates or taxes in respect of which the taxpayer has claimed a deduction either in the current year of income or in an earlier year of income, the recoupment will constitute an assessable recoupment and in turn assessable income by virtue of s 20-30(1) Table Item 1.2 of the *Income Tax Assessment Act 1997* (Cth). Section 20-25 defines a recoupment of a loss or outgoing as including:

(a) any kind of recoupment, reimbursement, refund, insurance, indemnity or recovery, however described; and

(b) a grant in respect of the loss or outgoing.

Where the amount of the recoupment for rates or taxes has been made the subject of a deduction under s 8-1 of the Act, the recoupment of those rates or taxes will be an assessable recoupment under s 20-20 and in turn will be assessable income under s 20-30.

Employee Obligations

[31.4.1280] Employee expenses incurred in the ordinary course of the taxpayer's business are generally deductible. These expenses include wages and salary as well as annual leave, sick leave, long service leave or redundancy or like payments and are deductible under s 8-1 of the *Income Tax Assessment Act 1997* (Cth). If the expenses relate to the creation of a capital asset, the wage and salary expenses relate to the creation of a capital asset, wage and salary expenses may be non-deductible but may form part of the cost of the asset for the purpose of calculating depreciation or like deductions.[1]

An issue arising in this area is whether or not the outgoing in question is "incurred" under s 8-1 of the *Income Tax Assessment Act 1997*. It has been held that a provision for annual leave, long service leave or sick leave is not deductible, although a deduction is available when the leave is actually paid.[2] Section 26-10 provides that a deduction for long service leave, annual leave, sick leave or other leave is generally not allowable until such time as payment is made.

An exception to the rule established by s 26-10 arises where an "accrued leave transfer payment" is made. An accrued leave transfer payment is a payment by one taxpayer to another in respect of long service leave, annual leave, sick leave or other leave which has accrued to an employee of the first taxpayer contemporaneously with the termination of the employee's employment by the first taxpayer and the hiring of the employee by the second employee, provided the payment is made under or to facilitate the provisions of a law of the Commonwealth, a State or a Territory or under an award, order or determination or an industrial agreement in force under such a law.[3] However, the effect of the exception is probably to do no more than make the deductibility of the payment depend upon the general principles applicable under s 8-1.

Where a deduction is not available under s 8-1 for a redundancy payment, a deduction is available for a pension, a gratuity or retiring allowance made to an employee, former employee or dependant of an employee or former employee under s 25-50 of the *Income Tax Assessment Act 1997*. The qualification to a deduction under s 25-50 is that the deduction is only available to the extent that it is made in good faith in consideration of the past services of the employee or former employee in any business that the taxpayer carried on for the purpose of gaining or producing assessable income.[4] There is also a denial of the deduction arising under s 25-50 if the pension, gratuity or retiring allowance is otherwise deductible under another provision of the *Income Tax Assessment Act 1997*.[5]

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1 See, eg *Goodman Fielder Wattie Ltd v Commissioner of Taxation* (1991) 29 FCR 376; 22 ATR 26, 394–395 (Hill J) (FCR).

2 *Nilsen Development Laboratories Pty Ltd v Federal Commissioner of Taxation* (1981) 144 CLR 616; 55 ALJR 97; 11 ATR 505; *Federal Commissioner of Taxation v James Flood Pty Ltd* (1953) 88 CLR 492; 10 ATD 240.

3 *Income Tax Assessment Act 1997* (Cth) s 26-10(2).

4 *Income Tax Assessment Act 1997* (Cth) s 25-50(2).

5 *Income Tax Assessment Act 1997* (Cth) s 25-50(3).

Payments Made under Guarantee or Indemnity

[31.4.1290] A payment made by a guarantor or surety under a guarantee or indemnity on the basis that the debtor for whose benefit it was made will repay it,[1] is not deductible under s 8-1 of the *Income Tax Assessment Act 1997* (Cth). The payment is not deductible because it is an outlay to be repaid at a later date rather than an outgoing never to be reimbursed.[2] A different conclusion results, however, where at the time of making the payment the creditor's right of subrogation of the guarantor or surety is worthless.[3] In this situation the payment can truly be said to be an outgoing and is deductible under s 8-1 if it satisfies the requirements of being relevant and incidental to the derivation of assessable income by the taxpayer and is not capital in nature.

A guarantee or indemnity payment by a guarantor or surety is deductible as a loss or outgoing:

(1) where it is irrecoverable from the debtor under the statutory right of subrogation at the time of its payment; and

(2) where the guarantee was given by the taxpayer in the ordinary course of a business conducted to gain or earn assessable income and can be regarded as a normal incident of that business.[4]

Where a guarantee or indemnity is given by one company for the benefit of a related company (eg by a holding company for the benefit of its subsidiary), the characterisation of the payment by the debtor which is guaranteed or indemnified determines the character of the guarantee or indemnity payment; a payment by the debtor on revenue account which is guaranteed ensures that the payment under the guarantee is likewise on revenue account.[5] For example, a guarantee of a related company's obligations to pay for trading stock is deductible where and when it is irrecoverable. But deductibility depends on having an interest in the debtor for whose benefit the guarantee is given. Where no such interest exists this affects the deductibility of an irrecoverable guarantee or indemnity payment. A guarantee payment made for the benefit of the taxpayer's supplier was held to be a capital outgoing in *Charles Marsden & Sons Ltd v Inland Revenue Commissioners* (1919) 12 TC 217.[6]

The principle that a compensation payment takes the character of the receipt that it is a substitute for as a matter of logic must also require that a guarantee or indemnity payment takes the same character as the payment for which it substitutes.

If a payment under a guarantee is denied deductibility under former s 51 of the *Income Tax Assessment Act 1936* (Cth) (see now s 8-1 of the *Income Tax Assessment Act 1997*) because it is of a capital nature, it may nevertheless be deductible under former s 67 of the *Income Tax Assessment Act 1936* (borrowing expenses – see now s 25-25 of the *Income Tax Assessment Act 1997*).[7]

It is also necessary to consider whether a deduction may be available under the provisions of s 70B of the *Income Tax Assessment Act 1936*, which allows a tax deduction for the loss on disposal of a "traditional security": see [31.4.1590]. In *Taxation Ruling TR 96/14* the Commissioner of Taxation rejects the argument that the liability of a debtor to a guarantor can be a traditional security.[8] However, this conclusion appears to be inconsistent with the wide definition of "security" in s 159GP(1) of the *Income Tax Assessment Act 1936* (Cth).

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1 This can be either under a contractual obligation between the guarantor or surety and the debtor or, more likely, by operation of law under the guarantor's or surety's statutory right of subrogation against the debtor (pursuant to *Law Reform (Miscellaneous Provisions) Act 1965* (NSW), s 3(1) and its equivalent provisions in other Australian states, replacing *Usury, Bills of Lading and Written Memoranda Act 1902* (NSW), s 8A (repealed)).

2 *Ransburg Australia Pty Ltd v Federal Commissioner of Taxation* (1980) 47 FLR 177; 10 ATR 663 (FCAFC).

3 It may be worthless because of insolvency or bankruptcy, such that the right of subrogation will ultimately be extinguished on the debtor's ultimate discharge from bankruptcy, or because the debtor is otherwise impecunious.

4 See, eg *Jennings v Barfield & Barfield* [1962] 1 WLR 997 (Ch).

5 See, eg *Case 57* (1969) 15 CTBR (NS) 357 (Full Board).

6 In *Charles Marsden & Sons Ltd v Inland Revenue Commissioners* (1919) 12 TC 217, (Rowlatt J) held that the loan made there for the benefit of a new supplier to the taxpayer was on capital account as it was made "in order to establish [a] source of … supply".

7 *Ure v Federal Commissioner of Taxation* (1981) 50 FLR 219; 11 ATR 484 (FCAFC), 235–236 (Deane and Shepherd JJ) (FLR).

8 Australian Taxation Office, *Income Tax: Traditional Securities*, TR 96/14, 15 May 1996.

[31.4.1300] Where the nature of the benefit or advantage sought by a taxpayer in making a guarantee payment or an indemnity payment was for the purpose of strengthening, preserving or expanding the business structure of the taxpayer, the payments made pursuant to the guarantee are of a capital nature and are not deductible.[1] This proposition is not affected by the fact that the debtor receiving the benefit of the guarantee was already a customer of the taxpayer because the issue is not whether the object in making the guarantee payment was to enable the taxpayer to carry on its business profitably but whether the means adopted to achieve that end involved the incurring of liabilities which were capital in character.[2]

1 *Bell & Moir Corp Pty Ltd v Federal Commissioner of Taxation* (1999) 42 ATR 421; [1999] FCA 1009.
2 *Bell & Moir Corp Pty Ltd v Federal Commissioner of Taxation* (1999) 42 ATR 421; [1999] FCA 1009.

Foreign Currency Exchange Losses

[31.4.1310] A loss made due to movements in exchange rates related to dealings with assets or liabilities is deductible if the assets or liabilities in question are held on revenue account. Exchange gains or losses commonly arise on the extinguishment of debts. A loss arises if a taxpayer who owes a debt is required to repay more in Australian currency than was obtained from the lender when borrowing it in foreign currency. Similarly, a taxpayer may own a debt as an asset and receive on repayment of it a lesser amount than was lent. Alternatively, a taxpayer may have assigned the benefit of the debt and received as consideration for the assignment an amount in foreign currency which on conversion to Australian currency realises a lesser amount than its face value.

An essential requirement for the recognition of a deduction (or assessable income if a gain is made) is that the loss must be realised.[1] Unrealised losses may be recognised for accounting purposes but are not tax deductible. Realisation requires that the asset or liability has been realised in Australian currency.[2] It is not sufficient if a loan is extended or a new creditor substituted for the original creditor.[3] Thus, where the underlying debt is held or owed by the taxpayer on revenue account,[4] the discharge of that debt (either by or in favour of the taxpayer) in Australian currency is deductible under s 8-1 of the *Income Tax Assessment Act 1997* (Cth) if it generates an exchange loss. The exchange loss is incurred for the purposes of s 8-1 of the *Income Tax Assessment Act 1997* when the debt giving rise to that loss is discharged, there being no "loss emerging" accruals basis for accounting for such losses.[5]

Exchange gains and losses are on revenue account if they relate to the purchase or sale of trading stock[6] or, in the case of a finance company, to borrowings in the ordinary course of the company's business as a finance company.[7] Exchange gains and losses on borrowings for other revenue related purposes should also be on revenue account; however, it has been held that borrowings to finance the working capital requirements of a business are on capital account.[8]

The High Court considered the manner of calculating exchange gains and losses and the question of when such gains and losses are realised in *Federal Commissioner of Taxation v*

Energy Resources of Australia Ltd (1996) 185 CLR 66; 70 ALJR 629; 33 ATR 52. In *Federal Commissioner of Taxation v Energy Resources of Australia Ltd* the taxpayer issued a series of promissory notes in US dollars to finance its Australian mining operations. The promissory notes were issued to tenderers who purchased them at a discount on their face value. Successive issues of notes retired notes previously issued. Notes were never discharged in cash. No proceeds of notes were ever converted into Australian currency or remitted to Australia. The proceeds of the initial notes were used solely to discharge liabilities on an overseas bank facility. The taxpayer claimed a deduction for the Australian dollar equivalent of the cost of issuing and retiring the notes in United States (US) dollars (ie the difference between the face value and the issue price of the notes) as being analogous to an interest payment under former s 51(1) of the *Income Tax Assessment Act 1936* (Cth) (see now s 8-1 of the *Income Tax Assessment Act 1997*). The Commissioner of Taxation conceded that the costs of issuing and retiring the notes was an expense incurred on revenue account and was therefore an allowable deduction under former s 51(1).[9] However, the Commissioner contended that the cost of the discount was to be calculated by deducting the proceeds of the notes, converted into Australian dollars at the issue date, from the cost of discharging the notes, converted into Australian dollars at the maturity date of the notes.[10] That is, the Commissioner contended that the cost of the discounts should have been reduced by the notional exchange rate currency gain that the taxpayer would have derived had the proceeds of each successive issue of notes been converted into Australian dollars rather than being applied in US dollars to retire the then-maturing note issue.

The High Court held that this notional exchange rate currency gain should not be taken into account in calculating the discount incurred as an outgoing for former s 51(1) purposes on the issue and redemption of each note issued because there was no currency conversion and hence no exchange rate fluctuation gain derived at any time. The Court concluded that:

> The taxpayer, therefore, incurred its loss in the present case when the Euronotes [the original overseas facility referred to above] were issued. At that time, it received or was entitled to receive the proceeds of the sale of the notes in US dollars and incurred a present liability to pay the face value of the notes in US dollars. The difference between the two sums, when expressed in Australian dollars, was its loss for the purposes of s 51(1) and that loss arose when it incurred the liability to pay the face value of the notes.[11]

The one aspect of the taxpayer's case in *Federal Commissioner of Taxation v Energy Resources of Australia Ltd* (1996) 185 CLR 66; 70 ALJR 629; 33 ATR 52 which the High Court rejected was the taxpayer's contention as to the timing of the incurring of the discount as an outgoing for former s 51(1) purposes in the case of each note issue. The taxpayer contended that it incurred the discount on maturity of each note issue, which is the earliest that it could ascertain the amount of the Australian dollar equivalent required to discharge the US dollar face value of each note. However, the High Court,[12] applying the principle established in *Coles Myer Finance Ltd v Federal Commissioner of Taxation* (1993) 176 CLR 640; 67 ALJR 463; 25 ATR 95 held that, for the purpose of former s 51(1) a taxpayer incurs a liability in respect of a promissory note upon its issue and not upon its payment,[13] held that the discount was incurred on the issue date of each promissory note and that was the date at which the Australian dollar equivalent of the discount incurred in US dollars was to be calculated for former s 51(1) purposes.

1 *Texas Co (A'asia) Ltd v Federal Commissioner of Taxation* (1940) 63 CLR 382; 5 ATD 298; *Armco (Aust) Pty Ltd v Federal Commissioner of Taxation* (1948) 76 CLR 584; 8 ATD 335; *Caltex Ltd v Federal Commissioner of Taxation* (1960) 106 CLR 205; 33 ALJR 543; 12 ATD 170; *International Nickel Australia Ltd v Federal Commissioner of Taxation* (1977) 137 CLR 347; 51 ALJR 782; 7 ATR 739; *Thiess Toyota Pty Ltd v Federal Commissioner of Taxation* [1978] 1 NSWLR 723; (1978) 9 ATR 11; *Commercial & General Acceptance Ltd v Federal Commissioner of Taxation* (1977) 137 CLR 373; 51 ALJR 842; 7 ATR 716; *Federal Commissioner of Taxation v Cadbury-Fry Pascall (Aust) Ltd* (1979) 37 FLR 126; 10 ATR 55 (VSC); *Lombard Australia Ltd v Federal Commissioner of Taxation* (1980) 43 FLR 258; 10 ATR 743 (NSWSC); *Avco Financial Services Ltd v Federal Commissioner of Taxation* (1982) 150 CLR 510; 56 ALJR 668; 13 ATR 63; *Federal Commissioner of Taxation v Hunter Douglas Ltd* (1983) 78 FLR 182; 14 ATR 629 (FCAFC).

2 *Caltex Ltd v Federal Commissioner of Taxation* (1960) 106 CLR 205; 33 ALJR 543; 12 ATD 170; *Pattison v Marine Midland Ltd* [1984] AC 362; [1984] 2 WLR 11; *Federal Commissioner of Taxation v Energy Resources of Australia Ltd* (1996) 185 CLR 66; 70 ALJR 629; 33 ATR 52.

3 *Caltex Ltd v Federal Commissioner of Taxation* (1960) 106 CLR 205; 33 ALJR 543; 12 ATD 170.

4 For example, such as money owed for the sale of trading stock or the rendering of services, the lending of money in the course of a money-lending business or money owed by way of licence fees for the use of industrial or intellectual property owned by the taxpayer.

5 *Texas Co (A'asia) Ltd v Federal Commissioner of Taxation* (1940) 63 CLR 382; 5 ATD 298; *Armco (Aust) Pty Ltd v Federal Commissioner of Taxation* (1948) 76 CLR 584; 8 ATD 335; *Caltex Ltd v Federal Commissioner of Taxation* (1960) 106 CLR 205; 33 ALJR 543; 12 ATD 170.

6 *International Nickel Australia Ltd v Federal Commissioner of Taxation* (1977) 137 CLR 347; 51 ALJR 782; 7 ATR 739.

7 *Avco Financial Services Ltd v Federal Commissioner of Taxation* (1982) 150 CLR 510; 56 ALJR 668; 13 ATR 63. But see *Commercial & General Acceptance Ltd v Federal Commissioner of Taxation* (1977) 137 CLR 373; 51 ALJR 842; 7 ATR 716, in which borrowings by a finance company were held to be on capital account because they were for the purpose of strengthening the financial standing of the company.

8 *Federal Commissioner of Taxation v Hunter Douglas Ltd* (1983) 78 FLR 182; 14 ATR 629.

9 *Federal Commissioner of Taxation v Energy Resources of Australia Ltd* (1996) 185 CLR 66; 70 ALJR 629; 33 ATR 52, 72–73 (the Court) (CLR).

10 *Federal Commissioner of Taxation v Energy Resources of Australia Ltd* (1996) 185 CLR 66; 70 ALJR 629; 33 ATR 52, 72–73 (the Court) (CLR).

11 *Federal Commissioner of Taxation v Energy Resources of Australia Ltd* (1996) 185 CLR 66; 70 ALJR 629; 33 ATR 52, 75–76 (the Court) (CLR).

12 *Federal Commissioner of Taxation v Energy Resources of Australia Ltd* (1996) 185 CLR 66; 70 ALJR 629; 33 ATR 52, 74–76 (the Court) (CLR).

13 *Coles Myer Finance Ltd v Federal Commissioner of Taxation* (1993) 176 CLR 640; 67 ALJR 463; 25 ATR 95, 659–660, 665 (Mason CJ, Brennan, Dawson, Toohey and Gaudron JJ) (CLR).

[31.4.1320] Part 4-5 Div 775 of the *Income Tax Assessment Act 1997* (Cth) establishes a regime for allowing deductions for foreign currency exchange losses (forex realisation losses) arising out of contracts entered into from the 2003–2004 income year.[1] Further, Pt 4-5 Div 775 does not apply if the foreign exchange loss arises under a financial arrangement covered by Pt 3-10 Div 230.[2]

Section 775-30 of the *Income Tax Assessment Act 1997* provides that "forex realisation losses" made as a result of an applicable "forex realisation event" are deductible in the year of the "forex realisation event". The "forex realisation loss" must arise as a result of forex realisation events 2 and 4,[3] happening to a right or an obligation obtained in relation to capital gains tax (CGT) assets, and the gain or loss would be taken into account under the CGT provisions.[4] There are exceptions to the deduction: losses of a private or domestic nature,[5] and losses made in gaining or producing exempt income or non-assessable non-exempt income are not deductible.[6]

Forex realisation event 2[7] occurs when the taxpayer ceases to have a right to receive foreign currency (but not from disposing the right), and the right must be one of the following:

(1) a right to receive income, or a right that represents ordinary income or statutory income (other than under the CGT provisions);

(2) a right created in return for ceasing to hold a depreciating asset;

(3) a right created or acquired for paying or agreeing to pay Australian or foreign currency; or

(4) a right created in return for a realisation event happening to a CGT asset.

Under forex realisation event 2, a “forex realisation loss” occurs if:

(1) the amount received is less than the “forex cost base”[8] and the shortfall is attributable to a currency exchange rate effect, then the amount attributable to the currency exchange rate effect[9] is the amount of the “forex realisation loss”; or

(2) an option to buy foreign currency expires. Then the amount you paid for the option is the amount of the “forex realisation loss”.

Forex realisation event 4[10] occurs when the taxpayer ceases to have a right to receive foreign currency, and the obligation was one of the following:

(1) obligations that are a deductible expense;

(2) obligations that are an element in the calculation of a net assessable or deductible amount;

(3) obligations that are incurred and form elements of the cost base of a CGT asset;

(4) obligations that are incurred in relation to a depreciating asset, or a project amount, under the capital allowances regime; or

(5) obligations incurred in return for receiving or the right to receive Australian or foreign currency.

Under forex realisation event 4, you make a “forex realisation loss” if the amount paid to satisfy the obligation is more than the proceeds of assuming the obligation, to the extent that the loss is due to a currency exchange rate effect.

Section 775-75 provides that, unless elected otherwise pursuant to s 775-80, certain short-term forex realisation losses (less than 12 months) are not taken into account under Pt 4-5 Div 775 but under the CGT provisions.

Part 4-5 Div 775 contains a number of anti-avoidance provisions. Section 775-110 provides for constructive receipts and payment when the amount was applied or dealt with under the receipt’s directions. Section 775-115 construes an economic set-off as treated as a legal set-off, with the effect that the parties are deemed to have paid and received the respective amounts. Section 775-120 contains the market value substitution rule where the parties are not dealing at arm's length.

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1 *Income Tax Assessment Act 1997* (Cth) s 775-155.
2 *Income Tax Assessment Act 1997* (Cth) s 230-20. For discussion of the taxation of financial arrangements, see "Financial Arrangements" [31.3.520]–[31.3.560].
3 *Income Tax Assessment Act 1997* (Cth) s 775-30(2)(b).
4 *Income Tax Assessment Act 1997* (Cth) s 775-30(2)(b).
5 *Income Tax Assessment Act 1997* (Cth) s 775-30(2)(a).
6 *Income Tax Assessment Act 1997* (Cth) s 775-35.
7 *Income Tax Assessment Act 1997* (Cth) s 775-45.
8 *Income Tax Assessment Act 1997* (Cth) s 775-85.
9 *Income Tax Assessment Act 1997* (Cth) s 775-105.
10 *Income Tax Assessment Act 1997* (Cth) s 775-55.

Fees Paid to Professional, Trade and Employee Associations

[31.4.1330] Payments made to professional, trade and employee associations are deductible pursuant to a specific statutory provision. Section 25-55 of the *Income Tax Assessment Act 1997* (Cth) provides a deduction for a taxpayer in respect of membership of a professional, trade or business or professional association. There are no conditions stated for the availability of this deduction which is limited to $42. In effect this provision gives a taxpayer a deduction of $42 per association subscription paid each year regardless of its ability to satisfy the tests of relevance and working nature in either of the positive limbs of s 8-1 of the *Income Tax Assessment Act 1997*: see [31.4.160].

If a taxpayer's professional membership satisfies the tests of deductibility in s 8-1, then a deduction without limit for the full costs of that membership is available under s 8-1.

A deduction is available to an employee for subscriptions to an association or union if the subscription was incurred for a purpose which is incidental and relevant to the taxpayer's employment.

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Statutory Deductions

Depreciation

[31.4.1440] Part 2-10 Div 40 of the *Income Tax Assessment Act 1997* (Cth) contains the capital allowances regime, which allows deductions for the depreciation and amortisation of certain wasting assets (that is, assets that do not exist indefinitely) held by the taxpayer and used during the year of income for the purpose of producing assessable income.[1] The operative provision of Pt 2-10 Div 40 allows a specific deduction equal to the decline in value for an income year (as worked out under the Division) of a depreciating asset held by the taxpayer for any time during the year.[2]

"Depreciation" refers to the reduction in effectiveness of an asset due to wastage or exhaustion and thus the reduction in the value of the asset in question during the year of income in which it has been used by the taxpayer to produce assessable income. Deductions for depreciation are determined by systematically allocating the cost of an asset over its effective life.

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1 See *Income Tax Assessment Act 1997* (Cth) s 40-15.
2 *Income Tax Assessment Act 1997* (Cth) s 40-25.

[31.4.1450] There are six core elements to the capital allowances regime under Pt 2-10 Div 40 of the *Income Tax Assessment Act 1997* (Cth). They may be summarised as follows:

(1) the asset must be a depreciating asset as defined under s 40-30 of the *Income Tax Assessment Act 1997* (see [31.4.1460]);

(2) the depreciating asset must have been held by the taxpayer during the year of income when it was used to produce assessable income (see [31.4.1470]);

(3) the taxpayer must choose between the diminishing value method and the prime cost method to calculate the decline in value of the depreciating asset (see [31.4.1480]);

(4) the taxpayer must determine the effective life of the asset (see [31.4.1490]);

(5) the taxpayer must determine the cost of the depreciating asset (see [31.4.1500]); and

(6) upon disposal of a depreciating asset, a balancing adjustment event occurs such that an amount may be required to be included or deducted from assessable income: see [31.4.1510].

[31.4.1460] Part 2-10 Div 40 of the *Income Tax Assessment Act 1997* (Cth) only applies to "depreciating assets" as defined in s 40-30. A "depreciating asset" is an asset that has a limited effective life and can reasonably be expected to decline in value over the time it is used.[1] Land, trading stock[2] and intangible assets are specifically excluded from the definition of "depreciating asset". Although excluded from the general definition of depreciating assets, certain specific types of intangible assets are specifically included in the definition of depreciating assets.[3] These include mining, quarrying or prospecting rights and information,[4] items of intellectual property,[5] in-house software,[6] IRUs,[7] spectrum licences,[8] datacasting transmitter licences,[9] and telecommunications site access rights.[10] There are certain assets which may fall within the definition of depreciating assets but for which you are excluded from deducting an amount under s 40-25 of the *Income Tax Assessment Act 1997*,[11] including assets for which you deduct amounts under Pt 2-10 Div 40 Subdiv 40-F (concerning primary production depreciating assets), Pt 2-10 Div 40 Subdiv 40-G (concerning capital expenditure of primary producers and other landholders) or Pt 2-10 Div 40 Subdiv 40-J (concerning capital expenditure for the establishment of trees in carbon sink forests).[12]

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1 *Income Tax Assessment Act 1997* (Cth) s 40-30(1).

2 As defined under *Income Tax Assessment Act 1997* (Cth) s 70-10 (meaning of "trading stock").

3 *Income Tax Assessment Act 1997* (Cth) s 40-30(2).

4 "Mining, quarrying or prospecting information" has the meaning given by *Income Tax Assessment Act 1997* (Cth) s 40-730(8). "Mining, quarrying or prospecting right" is defined under *Income Tax Assessment Act 1997* s 995-1(1).

5 As defined under *Income Tax Assessment Act 1997* (Cth) s 995-1(1), an item of intellectual property consists of the rights (including equitable rights) that an entity has under a Commonwealth law as a patentee or licensee of a patent, owner or licensee of a registered design, or owner or licensee of a copyright, or of equivalent rights under a foreign law.

6 As defined under *Income Tax Assessment Act 1997* (Cth) s 995-1(1).

7 An IRU is an "indefeasible right to use a telecommunications cable system": *Income Tax Assessment Act 1997* (Cth) s 995-1(1).

8 As defined under *Income Tax Assessment Act 1997* (Cth) s 995-1(1); *Radiocommunications Act 1992* (Cth) s 5.

9 As defined under *Income Tax Assessment Act 1997* (Cth) s 995-1(1).

10 As defined under *Income Tax Assessment Act 1997* (Cth) s 995-1(1).

11 *Income Tax Assessment Act 1997* (Cth) ss 40-45, 40-50.

12 *Income Tax Assessment Act 1997* (Cth) s 40-50(1).

[31.4.1470] The depreciating asset must have been held[1] by the taxpayer during the year of income when it was used to produce assessable income. The meaning of "holder" of a depreciating asset is set out under s 40-40 of the *Income Tax Assessment Act 1997* (Cth). Section 40-40 states that the holder of a depreciating asset is to be determined by reference to the table that is included under that section. Section 40-40 Table Item 10 indicates that the owner is typically the holder of a depreciating asset.[2] The legal owner may not be the holder of the following categories of assets:

(1) a car in respect of which a luxury car lease has been granted that was a luxury car when the lessor first leased it;[3]

(2) assets on leased land (whether fixtures or not) over which "quasi-ownership rights" exist;[4]

(3) other leased assets that are fixed to land where the lessor has a right to recover the asset;[5]

(4) certain intangible assets or rights that are legally owned by one person but exercisable by another;[6]

(5) assets subject to a right to purchase such as under hire purchase agreements;[7]

(6) partnership assets; or[8]

(7) mining, quarrying or prospecting information.[9]

Therefore, unless the depreciating asset is one which falls within one of the specific categories of assets listed above, the legal owner will be the holder of the depreciating asset.

(Cth) s 40-40 Table Items 8, 9.

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1 See *Income Tax Assessment Act 1997* (Cth) ss 40-25, 40-40.

2 If there is a separate legal and equitable ownership interest in the asset, the legal owner is the holder of the depreciating asset: *Income Tax Assessment Act 1997* (Cth) s 40-40 Table Item 10.

3 *Income Tax Assessment Act 1997* (Cth) s 40-40 Table Item 1. In this situation, the asset is held by the lessee (while the lessee has the right to use the car). A "luxury car" is defined under *Income Tax Assessment Act 1997* (Cth) s 995-1(1).

4 *Income Tax Assessment Act 1997* (Cth) s 40-40 Table Items 2, 3. Under these circumstances, the owner of the quasi-ownership right is the holder of the asset. "Quasi-ownership rights" is defined under *Income Tax Assessment Act 1997* (Cth) s 995-1(1). See also Australian Taxation Office, *Income Tax: Capital Allowances: Depreciating Asset – Hold – Fixtures on Land*, ATO ID 2004/957.

5 In this situation the lessor is the holder of the asset whilst the right to recover exists: see *Income Tax Assessment Act 1997* (Cth) s 40-40 Table Item 4.

6 The "economic owner" of the right *may* be treated as the holder of the right: *Income Tax Assessment Act 1997* (Cth) s 40-40 Table Item 5.

7 The "economic owner" may be deemed to be the holder of the asset: see *Income Tax Assessment Act 1997* (Cth) s 40-40 Table Item 6. See Australian Taxation Office, *Guide to Depreciating Assets 2016* (2016) and Australian Taxation Office, *Income Tax: Sale and Leasebacks*, TR 2006/13, 1 November 2006.

8 The partnership, and not any particular individual, will be the holder of the asset: *Income Tax Assessment Act 1997* (Cth) s 40-40 Table Item 7.

9 The holder will generally be the entity that has the information: see *Income Tax Assessment Act 1997* s 40–40 Table Items 8, 9.

[31.4.1480] Depreciation may be claimed using either the diminishing value method or the prime cost method. Section 40-65 of the *Income Tax Assessment Act 1997* (Cth) gives a taxpayer a choice as to the method of calculating the decline in value of a depreciating asset for an income year for the purposes of the deduction under s 40-25. The taxpayer can either use the diminishing value method[1] under s 40-70 or s 40-72 or the prime cost method[2] under s 40-75. Where the diminishing value method is chosen, if the taxpayer first started to hold the asset prior to 10 May 2006, a lower rate must be applied in determining the decline in value.[3] The diminishing value method is specifically excluded from being used to calculate the decline in value of intangible assets (only the prime cost method is available for these assets).[4] In order to calculate the decline in value under either of these two methods, the taxpayer must first determine the cost of the asset as worked out under Pt 2-10 Div 40 Subdiv 40-C of the *Income Tax Assessment Act 1997*, and the effective life of the asset under ss 40-95, 40-100 and 40-105.

For the purposes of claiming a deduction under s 40-25, a depreciating asset begins to decline in value from when the depreciating asset is first installed and ready for use.[5] Where a depreciating asset has been used for a non-taxable purpose, there is a reduction in the amount that can be deducted according to the proportion of use for taxable and non-taxable purposes.[6]

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1 For an example of this method, see the Australian Taxation Office website <http://www.ato.gov.au>.
2 For an example of this method, see the Australian Taxation Office website <http://www.ato.gov.au>.
3 *Income Tax Assessment Act 1997* (Cth) ss 40-72(1), 40-70.
4 *Income Tax Assessment Act 1997* (Cth) ss 40-72(2), 40-70(2).
5 *Income Tax Assessment Act 1997* (Cth) s 40-60.
6 *Income Tax Assessment Act 1997* (Cth) s 40-25(2).

[31.4.1490] In order to calculate the decline in value of a depreciating asset, the effective life of the asset must first be determined in accordance with s 40-95 of the *Income Tax Assessment Act 1997* (Cth). According to s 40-95, the taxpayer must choose to either use an effective life determined by the Commissioner under s 40-100 or the taxpayer may choose to self-assess the effective life of the asset in accordance with s 40-105. For certain intangible assets, the taxpayer does not have a choice in relation to determining the asset's effective life as these have been determined by legislation.[1] Where a taxpayer chooses to use the Commissioner's determination of effective life, generally the effective life of the asset is ascertained by the relevant Taxation Ruling that is in force at the earlier of the time when the asset is acquired, the time the contract is entered into or the time that construction is commenced.[2]

Where a taxpayer chooses to self-assess the effective life of a particular asset, the effective life of the asset must be worked out in accordance with s 40-105 of the *Income Tax Assessment Act 1997*. The taxpayer must estimate the period (in years, including fractions of years)[3] the asset can be used by any entity for a taxable purpose,[4] for the purpose of producing exempt income, non-assessable non-exempt income or for the purpose of conducting research and development activities (assuming that this is reasonably likely).[5] In estimating the period in accordance with s 40-105(1A), the taxpayer must have regard to the wear and tear that is reasonably expected from the taxpayer's circumstances of use and must assume that the asset will be maintained in reasonably good order and condition.[6] In estimating the period in accordance with s 40-105(1A), if the taxpayer decides that the asset is likely to be scrapped, abandoned or sold for scrap value prior to the period as estimated, the effective life of the asset ends at the earlier time when the asset is likely to be scrapped, abandoned or sold for scrap value.[7]

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1 *Income Tax Assessment Act 1997* (Cth) s 40-95(7). The list includes patents, registered designs, copyright, in-house software, spectrum licences, datacasting transmitter licences and telecommunications site access rights.
2 *Income Tax Assessment Act 1997* (Cth) s 40-95(2). See Australian Taxation Office, *Income Tax: Effective Life of Depreciating Assets (Applicable from 1 July 2016)*, TR 2016/1, 29 June 2016 for the most recent determinations by the Commissioner.

3 *Income Tax Assessment Act 1997* (Cth) s 40-105(1A).
4 "Taxable purpose" is the purpose of producing assessable income, exploration or prospecting, mining site rehabilitation or environmental protection activities, as defined under *Income Tax Assessment Act 1997* (Cth) s 40-25(7).
5 *Income Tax Assessment Act 1997* (Cth) s 40-105(1A). In estimating the period, the start time of the period is when the asset will be first installed and ready for use: *Income Tax Assessment Act 1997* s 40-105(3).
6 *Income Tax Assessment Act 1997* (Cth) s 40-105(2).
7 *Income Tax Assessment Act 1997* (Cth) s 40-105(3).

[31.4.1500] The cost of a depreciating asset is determined in accordance with Pt 2-10 Div 40 Subdiv 40-C of the *Income Tax Assessment Act 1997* (Cth). The cost of a depreciating asset consists of two elements.[1] The first element of cost is worked out at the time when the taxpayer began to hold the depreciating asset.[2] This element generally represents the amount that a taxpayer has paid to hold an asset.[3] There are specific rules for calculating the first element of cost in particular situations and where certain events happen to the asset.[4] However, unless one of the specific circumstances specified in the table set out in s 40-180(2) of the *Income Tax Assessment Act 1997* apply, the first element of cost is the amount that the taxpayer is taken to have paid to hold the asset.[5] This amount has to be worked out in accordance with s 40-185. The effect of s 40-185 is that in working out the amount that a taxpayer is taken to have paid under Pt 2-10 Div 40 of the *Income Tax Assessment Act 1997*, the taxpayer must take into account the sum of all amounts paid, liabilities incurred and non-cash benefits provided.

The second element of cost generally represents the costs incurred from time to time, after an asset is acquired, in order to bring the asset to its present condition and location.[6] Whereas the first element of cost is determined only once (when the taxpayer first begins to hold the asset), the second element of cost is determined "from time to time" after the asset is acquired, that is, as and when further costs are incurred in bringing the asset to its present condition and location. The second element of cost is taken into account in calculating the decline in value of a depreciating asset by adding the second element of cost to the opening adjustable value of the depreciating asset at the start of the income year during which the cost is incurred.[7]

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1 *Income Tax Assessment Act 1997* (Cth) s 40-175.
2 *Income Tax Assessment Act 1997* (Cth) s 40-180(1).
3 *Income Tax Assessment Act 1997* (Cth) s 40-180(1)(b).
4 *Income Tax Assessment Act 1997* (Cth) s 40-180(1), (2). For example, there is a market value substitution rule which may apply in certain circumstances pursuant to s 40-180(2) Table Item 8.
5 *Income Tax Assessment Act 1997* (Cth) s 40-180(1)(b).
6 *Income Tax Assessment Act 1997* (Cth) s 40-190(2).
7 *Income Tax Assessment Act 1997* (Cth) ss 40-70(1)(b), 40-75(2)(b), 40-85(1)(c).

[31.4.1510] Upon disposal of a unit of a depreciating asset a taxpayer may be required to include an amount in assessable income or become entitled to a further deduction. Part 2-10 Div 40 Subdiv 40-D of the *Income Tax Assessment Act 1997* (Cth) deals with the consequences of disposing of or the loss or destruction of depreciating assets. This section is colloquially termed a "claw back" provision. Part 2-10 Div 40 Subdiv 40-D gives a deduction for the excess of the adjustable value of the asset[1] (ie the cost remaining net of all capital allowance deductions claimed under s 40-25 up to that point) over the termination value of the asset (ie the amount you are taken to receive as consideration for the balancing adjustment event occurring);[2] in effect, a deduction for the loss on the sale or other disposal of the property net of the deductions already taken under s 40-25. Part 2-10 Div 40 Subdiv 40-D symmetrically renders assessable that part of the excess of the termination value over the adjustable value of the property at the disposal date which represents deductions claimed under s 40-25, hence the term "claw back" of tax benefits from the taxpayer by the Commissioner.

Where the taxpayer and the recipient of the item of plant are not dealing with each other at arm's length and the amount receivable by the taxpayer is less than the market value of the item of plant at the disposal date then the consideration received by the taxpayer for the disposal is deemed to be its market value at that date.[3] Where an asset has been used for a non-taxable purpose, there is a reduction in the amount to be included or deducted from a taxpayer's assessable income, depending on the proportion of non-taxable pursuant to s 40-290 of the *Income Tax Assessment Act 1997*.

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1 For the meaning of "adjustable value", see *Income Tax Assessment Act 1997* (Cth) s 40-85.
2 *Income Tax Assessment Act 1997* (Cth) s 40-300.
3 *Income Tax Assessment Act 1997* (Cth) s 40-300(2) Table Item 6.

Borrowing Expenses

[31.4.1520] The cost of borrowing money which a taxpayer will use in the production of assessable income is tax deductible. Under s 25-25 of the *Income Tax Assessment Act 1997* (Cth), the essential aspects of the deduction are:

(1) It is allowable based on the proportion that the year of income bears to the term of the loan. For example, a three-year loan will give a 33.33 percent per annum deduction for the borrowing costs.[1]

(2) There is a maximum loan term of five years so that all loans of five years or more will give rise to a 20 percent per annum deduction for the borrowing costs.[2]

(3) Where the borrowing costs are less than $100 (a de minimus threshold long since made virtually redundant by inflation), then the entire borrowing cost is a deduction in the year of income in which the loan is undertaken.[3]

(4) Where there is only a partial income earning use for the borrowed money, the taxpayer must only deduct a proportion of the borrowing expenses having regard to the extent that the borrowed money was used for the purpose of producing assessable income.[4]

The types of expenses which are deductible under s 25-25 are valuation fees, legal costs and guarantee fees[5] and the deduction under s 25-25 is available despite the absence of the borrowing expenses having a working nature because s 25-25 contains only a relevance criterion ("use the money for the purpose of producing assessable income"). The one-off nature of such expenditure does not defeat a deduction entitlement under s 25-25.

The balance of undeducted borrowing expenses carried forward may be reduced to the extent that the taxpayer has been forgiven a debt: see also [31.4.1730]–[31.4.1740].

Leaving aside s 25-25, a taxpayer whose business is the borrowing and lending of money may claim borrowing expenses outright under s 8-1 of the *Income Tax Assessment Act 1997* on the basis that borrowing expenses are a recurrent outgoing incurred in the ordinary course of the business of such a taxpayer.

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1 *Income Tax Assessment Act 1997* (Cth) s 25-25.
2 *Income Tax Assessment Act 1997* (Cth) s 25-25(5).
3 *Income Tax Assessment Act 1997* (Cth) s 25-25(6).
4 *Income Tax Assessment Act 1997* (Cth) s 25-25(3).
5 *Ure v Federal Commissioner of Taxation* (1981) 50 FLR 219; 11 ATR 484 (FCAFC). See also Australian Taxation Office, *Income Tax: Borrowing Expenses Passed on to a Subsidiary*, ATO ID 2009/51, 22 June 2009.

[31.4.1530] The cost of discharging a mortgage securing a loan which was used to produce assessable income is deductible under s 25-30 of the *Income Tax Assessment Act 1997* (Cth). A deduction is also available if the mortgage was granted to secure an obligation to pay for the purchase of property which, when acquired by the taxpayer, was used to produce assessable income. The underlying loan or property being purchased need not be a revenue asset or otherwise be held on revenue account. The section gives a deduction for an expense which has relevance to the derivation of assessable income but which need not have any working character at all – it can be entirely an affair of capital and still be totally deductible in the year of expenditure under s 25-30. Where the loan or property being acquired is only partly used to produce assessable income, a taxpayer must only deduct a proportion of the cost having regard to the extent that the borrowed money was used for the purpose of producing assessable income.

Expenses Relating to Leases

[31.4.1540] A specific deduction is available under s 25-20 of the *Income Tax Assessment Act 1997* (Cth) for the full amount of expenditure incurred in preparing a lease or in surrendering or assigning a lease of property intended to be used or which has been used to produce assessable income. On a general principle application of s 8-1 of the *Income Tax Assessment Act 1997*, such expenditure would lack any working character as it is an affair of capital, being part of the cost of acquiring a structural asset of the business of the taxpayer. This does not defeat the entitlement to a deduction under this provision because, like s 25-30 of the *Income Tax Assessment Act 1997*, s 25-20 is only concerned with relevance to the derivation of assessable income. It is simply a provision giving a one-off deduction in the year of payment for the capital cost of preparing, registering and stamping lease documents for a lease of property that will be used for producing assessable income.

Capital Expenditure: Buildings and Structural Improvements

[31.4.1550] Part 2-10 Div 43 of the *Income Tax Assessment Act 1997* (Cth) gives a deduction for the amount of capital works, which include buildings, structural improvements and environment protection earthworks.[1] Section 43-10 gives a deduction for capital works. Section 43-20 provides that capital works means a building or an extension, alteration or improvement to a building begun in Australia after 21 August 1979 or begun outside Australia after 21 August 1990. Section 43-20(2) gives a deduction for capital works begun after 26 February 1992 other than those relating to buildings that are structural improvements or extensions, alterations or improvements to structural improvements whether in or outside Australia. Examples of such non-building structural improvements are sealed roads, sealed driveways, earthworks integral to the construction of a structural improvement such as embankments, culverts, tunnels for a runway, road or railway and so forth. These structural improvements do not extend to earthworks that are not integral to the installation or construction of a structure, which are permanent and which can be economically maintained in reasonably good order and condition for an indefinite period, such as, for example, channels, basins, earthtanks and dirt tracks.

Section 43-20(5) gives a deduction for capital works being earthworks, extensions, alterations or improvements to earthworks if constructed as a result of the carrying out of "environmental protection activities",[2] if they can be economically maintained in reasonably good order and condition for an indefinite period, and if they are not integral to the construction of capital works and where the expenditure on the capital works was incurred after 18 August 1992.

Section 43-25(1) provides that for capital works begun after 26 February 1992 there is a basic entitlement to a rate of 2.5 percent depreciation rate which increases to 4 percent in some circumstances. The precise rate depends on the use to which the capital works are put as denoted in the s 43-140 Table and the s 43-145 Table in Pt 2-10 Div 43. Section 43-25(2) provides that capital works begun before 27 February 1992 and used as described in the s 43-140 Table have a rate of deduction of 2.5 percent For those parts used in accordance with the s 43-145 Table there is a 4 percent rate of deduction. For capital works begun after 21 August 1984 and before 16 September 1987 a rate of 4 percent applies and a rate of 2.5 percent applies in any other case.

Section 43-30 provides that no deduction entitlement arises until the construction work is complete.

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1 *Income Tax Assessment Act 1997* (Cth) s 43-20 defines "capital works", to which Pt 2-10 Div 43 applies.

2 *Income Tax Assessment Act 1997* (Cth) s 40-755(2) defines "environmental protection activities", to which s 43-20(5) applies.

Gifts

[31.4.1560] Gifts made to certain organisations are tax deductible.[1] Part 2-5 Div 30 of the *Income Tax Assessment Act 1997* (Cth) contains a table which sets out the organisations to which deductible gifts may be made. In practice the easiest way of identifying organisations and funds that are eligible donees is to consult alphabetical lists published by the Australian Taxation Office and other publishers.[2] The criteria for claiming a deduction are as follows:

(1) the institution receiving the gift is in Australia;[3]

(2) the gift is made either by money, property purchased by the taxpayer during the year of income or property which is trading stock of the taxpayer;[4]

(3) the value of the gift is $2 or more;[5]

(4) the gift is not a testamentary gift (it must be made during the taxpayer's lifetime);[6]

(5) where the s 30-15 Table limits gifts to particular institutions to particular purposes, the gift is made to the particular institution for that particular purpose;[7] and

(6) if the gift is property, a deduction may be limited in accordance with the rules in the s 30-15 Table so as to ensure that there is no double deduction for the gift.[8]

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1 *Income Tax Assessment Act 1997* (Cth) s 30-15.
2 See, eg the "ABN Lookup" website, <https://abr.business.gov.au/DgrListing.aspx>.
3 *Income Tax Assessment Act 1997* (Cth) s 30-15.
4 *Income Tax Assessment Act 1997* (Cth) s 30-15.
5 *Income Tax Assessment Act 1997* (Cth) s 30-15.
6 *Income Tax Assessment Act 1997* (Cth) s 30-15(2).
7 *Income Tax Assessment Act 1997* (Cth) s 30-15.
8 *Income Tax Assessment Act 1997* (Cth) s 30-15.

[31.4.1570] In order to be deductible a gift must be made voluntarily without the donor becoming entitled to any compensation or advantage as a result of making the gift.[1] In *Rabinov v Federal Commissioner of Taxation* (1982) 64 FLR 414; 13 ATR 496, a gift made out of a taxpayer's own funds which was reimbursed by way of loans from an investment company associated with another company whose purpose was to procure gifts for the donee fund was held to be non-deductible.[2] After 7 April 1978, gifts to authorities or institutions which are otherwise deductible under Pt 2-5 Div 30 of the *Income Tax Assessment Act 1997* (Cth) are not deductible if the gift is made under an arrangement whereby the amount of the gift received by the donee is less than the nominal amount of the gift and the cost to the donor, by reason of some other factor, is less that the nominal amount of the gift.[3] The provision also applies to benefits received by "associates" of the donor.

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1 See Australian Taxation Office, *Income Tax: Tax Deductible Gifts – What is a Gift*, TR 2005/13, 20 July 2005.
2 *Rabinov v Federal Commissioner of Taxation* (1982) 64 FLR 414; 13 ATR 496.

3 *Income Tax Assessment Act 1997* (Cth) s 30-15(2) Table (in particular, the second and fourth columns).

Miscellaneous Deductions

[31.4.1580] Expenditure in respect of a "tax-related" matter being expenditure which is not of a capital nature is allowable as a deduction.[1] Section 25-5 of the *Income Tax Assessment Act 1997* (Cth) only provides a deduction in relation to certain "tax-related" expenditure. The deduction is allowable in full in the year in which the expenditure is incurred. The deduction is available for expenditure incurred in relation to the management or administration of the income tax affairs of the taxpayer or compliance with an obligation imposed by Commonwealth income tax laws. The deduction is also available for the "general interest charge", the "shortfall interest charge" and the penalty under Pt 4-7 Div 162 Subdiv 162-D of the *A New Tax System (Goods and Services Tax) Act 1999* (Cth).[2] Section 25-5 provides that expenditure is not to be taken to be of a capital nature merely because the expenditure was in respect of income tax affairs concerning matters of a capital nature. Section 25-5 provides that the statutory limits on the entitlement to a deduction under s 8-1 of the *Income Tax Assessment Act 1997* apply equally to s 25-5 of the *Income Tax Assessment Act 1997*.

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1 *Income Tax Assessment Act 1997* (Cth) s 25-5.

2 The "general interest charge" means the charge worked out under *Taxation Administration Act 1953* (Cth) Pt IIA. The "shortfall interest charge" means the charge worked out under *Taxation Administration Act 1953*, Sch 1 Div 280.

[31.4.1590] Section 70B of the *Income Tax Assessment Act 1936* (Cth) provides a deduction for the loss on the disposal or redemption of "traditional securities". Section 70B(2) provides a deduction for the loss incurred on the disposal or redemption of a traditional security in the year of the disposal or redemption. Section 70B(1) adopts the definitions of terms used in s 26BB which is the provision that renders assessable the profit derived on the disposal or redemption of a "traditional security". The term "traditional security" is defined in s 26BB(1) to mean a security acquired after 10 May 1989 which either does not have an eligible return (a term defined in s 159GP(1)) or where the eligible return is either unascertainable at the date of issue of the security or where the eligible return is below a de minimus threshold calculated using a formula.[1]

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1 The taxation treatment of traditional securities is discussed in "Interest and Like Payments" [31.3.310]–[31.3.510].

[31.4.1600] Election expenses incurred by candidates in elections to a Parliament of the Commonwealth, or of a State or of a Territory[1] are deductible. Also, election expenses incurred by candidates in elections for membership of a local government are also deductible up to a maximum limit of $1,000.[2] Sections 20-20 and 20-25 of the *Income Tax Assessment Act*

1997 (Cth) make the reimbursement of any such expenditure assessable in the year of receipt.

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1 *Income Tax Assessment Act 1997* (Cth) ss 25-60, 25-70.
2 *Income Tax Assessment Act 1997* (Cth) s 25-65.

[31.4.1610] Deductions are allowable for superannuation contributions made by taxpayers who are self-employed persons, employees or employers for the benefit of their employees.[1] Section 290-60 of the *Income Tax Assessment Act 1997* (Cth) provides a deduction for superannuation contributions made by a taxpayer for the purpose of providing superannuation benefits to another person who is an employee of the taxpayer provided that certain "employment activity conditions" and "complying fund conditions" are met. Section 290-70 of the *Income Tax Assessment Act 1997* sets out the "employment activity conditions" which must be satisfied for a taxpayer to deduct an employer contribution. The employee for whose benefit the contribution was made must be either an employee within the expanded meaning of "employee" given by s 12 of the *Superannuation Guarantee (Administration) Act 1992* (Cth), an employee who is engaged in producing the taxpayer's assessable income or an employee who is an Australian resident who is engaged in your business. Section 290-75 sets out the "complying fund conditions" which must be satisfied for a taxpayer to deduct an employer contribution. The contribution must have been made to a superannuation fund that is a "complying superannuation fund", which is defined as a fund which satisfies the conditions in s 45 of the *Superannuation Industry (Supervision) Act 1993* (Cth). Alternatively, at the time of the contribution, the taxpayer must have had reasonable grounds for believing that the fund was a complying superannuation fund for that income year, or before making the contribution, the employer taxpayer obtained a written statement from the fund that it was a "resident regulated superannuation fund" and was not prohibited from accepting employer contributions under s 63 of the *Superannuation Industry (Supervision) Act 1993*.

Section 290-150 allows for a deduction for superannuation contributions made by an individual taxpayer for a taxpayer's own benefit provided that certain conditions are satisfied. Section 290-155 states that the contribution must be made to a superannuation fund that is a "complying superannuation fund", which is defined as a fund that satisfies the conditions in s 45 of the *Superannuation Industry (Supervision) Act 1993*.

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1 *Income Tax Assessment Act 1997* (Cth) Pt 3-30 Div 290 Subdivs 290-B, 290-C: see "Superannuation" [31.1.1380]–[31.1.1540]. Superannuation is fully discussed in "Superannuation Funds and Other Special Entities" [31.10.10]ff.

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Deductibility and Carrying Forward of Losses

Carry Forward Losses

[31.4.1720] A deduction is allowable in a year of income for a loss carried forward from previous years of income. Part 2-5 Div 36 of the *Income Tax Assessment Act 1997* (Cth) establishes a regime for claiming a deduction for tax losses of earlier years. Section 36-10 of the *Income Tax Assessment Act 1997* defines when a taxpayer incurs a loss in a particular year of income. This occurs where the taxpayer's deductions for that year (other than carry forward losses from prior years) exceed the sum of the taxpayer's assessable income plus its net exempt income for that year.

Part 2-5 Div 36 gives a deduction to a taxpayer in the current year for undeducted prior year losses in the following manner:

(1) where the taxpayer has no net exempt income in that year the deduction of the carried forward loss is to be made against the taxpayer's assessable income for that year;

(2) where the taxpayer has a net exempt income in that year the deduction is made successively against the net exempt income[1] and then against the taxpayer's assessable income for that year; and

(3) where a deduction is allowable under s 36-15 for two or more losses, the losses are to be deducted in the order in which they were incurred; that is, first in first out.

A number of restrictions to the entitlement to carry forward prior year losses are imposed. In particular, s 165-12 prevents prior year losses from being taken into account in a subsequent year where there is not substantial continuity of beneficial ownership (more than 50 percent of the voting power, dividend or capital distribution rights) of a company between the years in which the losses were incurred and the year in which the deduction for them is claimed. Section 165-13 allows prior year losses to be taken into account in a year where, notwithstanding a failure to satisfy s 165-12, the company can satisfy the same business test.[2]

Some deductions cannot be included in the calculation of a carry forward loss.[3] The most important categories of deduction precluded from giving rise to a loss are gifts to approved funds and organisations allowable under Pt 2-5 Div 30 of the *Income Tax Assessment Act 1997*, pensions, gratuities or retiring allowances in respect of former employees allowable under s 25-50 and superannuation contributions deductible under s 290-150.

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1 "[N]et exempt income" is defined by *Income Tax Assessment Act 1997* (Cth) s 36-20 as being, in the case of a resident taxpayer, the amount by which a taxpayer's exempt income from all sources

exceeds the sum of the taxpayer's expenses of a revenue nature incurred in deriving that income and any foreign taxes payable in respect of that income. In the case of a non-resident taxpayer it is the amount by which the taxpayer's exempt income derived from sources in Australia (and certain film proceeds to which *Income Tax Assessment Act 1936* (Cth) s 26AG applies) exceeds the sum of the expenses of a revenue nature incurred in deriving that income (and any taxes payable outside Australia on income covered by s 26AG).

2 There are also further anti-avoidance provisions in of the *Income Tax Assessment Act 1997* (Cth) Pt 3-5 Div 175: see "Companies and Shareholders" [31.9.10]ff.

3 See *Income Tax Assessment Act 1997* (Cth) s 26-55.

[31.4.1730] The carry forward losses of a taxpayer may be reduced or forfeited in the event that debts owed by the taxpayer are forgiven. If a taxpayer becomes a bankrupt or has debts released by the operation of bankruptcy legislation no loss incurred by the taxpayer before becoming bankrupt or being released is able to be claimed as a tax deduction.[1] There is no direct counterpart of s 36-35 of the *Income Tax Assessment Act 1997* (Cth) applicable to companies which go into liquidation. However, the "commercial debt forgiveness provisions" may require a taxpayer to reduce carry forward losses to the extent that debts owed by the taxpayer have been forgiven.

The measures apply if a "commercial debt" is forgiven. A debt is a commercial debt if the whole or any part of the interest payable on the debt is or would be an allowable deduction to the debtor at any time during the term of the debt.[2] "Interest" includes amounts in the nature of interest. A "debt" is defined under the debt equity rules.[3] Interest accrued and unpaid is treated as a separate debt.[4] A debt is forgiven if the debtor's obligation to pay is released, waived or otherwise extinguished other than by repaying the debt in full.[5] The measures also apply if part of a debt is forgiven. A debt is also treated as forgiven if the creditor loses the right to sue for recovery pursuant to a statute of limitations.[6]

The measures may apply where a debt is assigned by a creditor to an associate of the debtor or to a person who has an arrangement with the debtor in relation to the debt.[7] In these circumstances, the measures apply as if the debt has been forgiven. The measures also apply where a company issues shares to the creditor and the company applies all or any of the money subscribed in or towards payment of the debt.[8]

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1 *Income Tax Assessment Act 1997* (Cth) s 36-35.

2 *Income Tax Assessment Act 1997* (Cth) s 245-10. Non-equity shares are also treated as a debt for s 245-10 purposes: s 245-15.

3 *Income Tax Assessment Act 1997* (Cth) s 974-20.

4 *Income Tax Assessment Act 1997* (Cth) s 245-20 (note).

5 *Income Tax Assessment Act 1997* (Cth) s 245-35(a).

6 *Income Tax Assessment Act 1997* (Cth) s 245-35(b). For the rules governing the limitation of actions, see *Civil Procedure* "Limitation of Actions" [5.10.10]ff.

7 *Income Tax Assessment Act 1997* (Cth) s 245-36(a).

8 *Income Tax Assessment Act 1997* (Cth) s 245-37.

[31.4.1740] Where debts owed by a taxpayer are forgiven, there are complex rules which govern the calculation of the amount which is taken to be forgiven. This amount is known as the "net forgiven amount". The starting point for the calculation is the "value" of the debt. The "value" is the value of the debt at the time of forgiveness determined as if the debtor's capacity to pay at the time of the forgiveness was the same as at the time when the debt was incurred (on the assumption that the debtor was solvent at the time the debt was incurred) reduced by any increase in the value of the debt attributable to changes in interest rates and exchange rates for which the debtor is not entitled to a tax deduction.[1]

The "gross forgiven amount" is the value of the debt less the consideration given for the forgiveness. If no consideration is given in respect of the forgiveness or the whole or part of the consideration cannot be valued or the debtor and the creditor are not dealing with each other at arm's length, and the forgiveness of the debt was a capital gains tax (CGT) event involving a taxable Australian property or involved an assignment, the amount of the consideration is deemed to be the market value of the debt at the time of the forgiveness.[2] This provision is extremely important. If a debt is forgiven and the debtor was solvent at the time, the market value of the debt should usually be its face value. Accordingly, the gross forgiven amount in such a case should be zero and the debtor is not required to adjust carry forward losses or other amounts as a consequence of these provisions.

The "net forgiven amount" is the amount which is applied against the debtor's carry forward losses and other tax balances. The net forgiven amount is the gross forgiven amount less:

(1) any amount included in the debtor's assessable income as a result of the forgiveness of the debt;

(2) the amount by which the forgiven debt already reduces the amount of a deduction otherwise allowable to the debtor; and

(3) the amount by which the forgiven debt already reduces the cost base of any CGT asset of the debtor.[3]

The net forgiven amount is applied to reduce the following amounts to nil in the order shown:[4]

(1) carry forward revenue losses;

(2) prior net capital losses;

(3) undeducted expenses – expenditure such as the cost of depreciable assets, undeducted borrowing expenses that would otherwise be deductible in the year of the forgiveness or a later year of income;[5]

(4) the cost base and reduced cost base of CGT assets of the debtor at the beginning of the year in which the forgiveness occurred, other than depreciable assets and certain other assets.

The commercial debt forgiveness provisions do not apply if the forgiveness is effected under bankruptcy law,[6] by a person's will,[7] for reasons of natural love and affection,[8] where the debt waiver is a fringe benefit[9] or where the debt forgiven will be included in the debtor's assessable income.[10]

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1 *Income Tax Assessment Act 1997* (Cth) s 245-55(2).
2 *Income Tax Assessment Act 1997* (Cth) s 245-65.

3 *Income Tax Assessment Act 1997* (Cth) s 245-85.
4 *Income Tax Assessment Act 1997* (Cth) ss 245-115, 245-130, 245-145.
5 See *Income Tax Assessment Act 1997* (Cth) s 245-145 for the list of relevant expenditures.
6 *Income Tax Assessment Act 1997* (Cth) s 245-40(c).
7 *Income Tax Assessment Act 1997* (Cth) s 245-40(d).
8 *Income Tax Assessment Act 1997* (Cth) s 245-40(e).
9 *Income Tax Assessment Act 1997* (Cth) s 245-40(a).
10 *Income Tax Assessment Act 1997* (Cth) s 245-40(b).

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Statutory Restrictions on Deductibility

General

[31.4.1860] Limitations are imposed on the deductibility of outgoings which generate assessable income in the form of a capital gain.[1] Section 51AAA of the *Income Tax Assessment Act 1936* (Cth) provides that where an amount is included in assessable income under s 102-5 of the *Income Tax Assessment Act 1997* (Cth),[2] and a deduction is otherwise allowable from the outgoing, but the outgoing only became deductible because of the inclusion of an amount in assessable income under s 102-5 of the Act, then the outgoing is not deductible. In effect s 51AAA prevents an outgoing which generates nothing more than a capital gain from being an allowable deduction against assessable income.

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1 *Income Tax Assessment Act 1936* (Cth) s 51AAA.
2 *Income Tax Assessment Act 1997* (Cth) s 102-5 operates to characterise all net capital gains as assessable income for the purposes of the Act.

Car Expenses

[31.4.1870] Car expenses are not deductible if incurred by an employee where the employee or a relative of the employee has an entitlement to use the car for private purposes during the period to which the expenditure on the car relates.[1] Section 51AF of the *Income Tax Assessment Act 1936* (Cth) denies a deduction where an employer provides a car for the exclusive use of an employee or a relative of an employee during a particular period and the employee or relative is entitled to use the car for private purposes.

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1 *Income Tax Assessment Act 1936* (Cth) s 51AF.

Car-parking Expenses

General

[31.4.1880] Specific statutory provisions deny a deduction or limit the deduction available for certain car-parking expenses of employees.[1] Car-parking expenses would in any event be non-deductible to an employee or self-employed taxpayer who travels from home to work by car but may be deductible under s 8-1 of the *Income Tax Assessment Act 1997* (Cth) if the parking is incurred in the course of travel for employment or business purposes. Section 51AGA is designed to ensure consistent treatment between employees whose employers provide car parking as a fringe benefit[2] on the one hand and employees who pay for their own car parking on the other.

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1 *Income Tax Assessment Act 1936* (Cth) s 51AGA.
2 In this case the employer is subject to fringe benefits tax: see "Fringe Benefits Tax (FBT)" [31.1.720]–[31.1.980].

Employees

[31.4.1890] Section 51AGA of the *Income Tax Assessment Act 1936* (Cth) denies a deduction to an employee for certain car-parking expenses. This relates to expenditure incurred in the provision of car-parking facilities for a car on a day on or after 1 July 1993 if the employee has a primary place of employment, the car is parked for four hours or more during daylight at or in the vicinity of the primary place of employment, the expenditure is in respect of those car-parking facilities, the car was used that day for travel between the employee's residence and the primary place of employment, and the regulations have not excluded the provision of those parking facilities from the section. The terms used in the section have the same meaning as they have in the *Fringe Benefits Tax Assessment Act 1986* (Cth).

Other Expenses Where Deductibility Is Restricted

[31.4.1900] Contributions under the *Student Assistance Act 1973* (Cth) or imposed by the *Higher Education Funding Act 1988* (Cth) are not allowable as deductions.[1] A deduction is denied for a student contribution amount within the meaning of the *Higher Education Support Act 2003* (Cth) paid to a higher education provider (within the meaning of that Act), a payment made to reduce a debt to the Commonwealth under Ch 4 of that Act or a payment made to reduce a debt to the Commonwealth or a participating corporation under Ch 2B of the *Social Security Act 1991* (Cth) or Pt 4A of the *Student Assistance Act 1973* (Cth).

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1 *Income Tax Assessment Act 1997* (Cth) s 26-20.

[31.4.1910] Certain superannuation levies are non-deductible. Deductions are not allowed in respect of the proportion of a levy imposed under the *Superannuation (Self Managed Superannuation Funds) Supervisory Levy Imposition Act 1991* (Cth), which represents the late lodgment amount.[1] A specific statutory provision also denies a deduction in respect of a charge imposed by the *Superannuation Guarantee Charge Act 1992* (Cth).[2] The levy is imposed on employers who fail to meet their obligations under the *Superannuation Guarantee Charge Act 1992* to provide superannuation benefits for employees in each year of income.

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1 *Income Tax Assessment Act 1997* (Cth) s 26-90. The late lodgement amount is defined in *Superannuation (Self Managed Superannuation Funds) Supervisory Levy Imposition Act 1991* (Cth) s 6.

2 *Income Tax Assessment Act 1997* (Cth) s 26-95.

[31.4.1920] Expenditure relating to leisure facilities and memberships of certain clubs is not allowable as a deduction.[1] Sections 26-45 and 26-50 of the *Income Tax Assessment Act 1997* (Cth) are the operative provisions which state what types of expenditure are caught by the sections. Essentially two kinds of expenditure are disallowed by these provisions: expenditure incurred in obtaining membership of a recreational club and expenditure on leisure facilities. A loss or outgoing is disallowed under ss 26-45 and 26-50 to the extent to which it is incurred in securing or maintaining club membership or rights to enjoy club facilities or for or in connection with the acquisition of ownership of a leisure facility, or a right to use a leisure facility, retention of ownership of a leisure facility or rights to use the facility, payment of an obligation associated with ownership of or a right to use a leisure facility, or the use, operation, maintenance or repair of a leisure facility. Sections 26-45 and 26-50 do not stop you from deducting expenditure that is incurred in providing a fringe benefit.[2]

"Recreational club" means any company[3] providing recreational, drinking, dining or entertainment facilities for members,[4] while a "leisure facility" means land, a building or part of a building or other structure, that is used or held for use for holidays or recreation.[5] An exception applies under s 26-50(3) where the leisure facility is held for sale in the ordinary course of the taxpayer's business of selling leisure facilities or providing leisure facilities for payment, or where the leisure facility is used mainly to produce the taxpayer's assessable income in the nature rents, lease premiums, licence fees or similar charges. A further exception under s 26-50(3) is where the leisure facility is held by an employer for use by its employees or for the care of the employees' children. The exception does not apply however to employees who are members or directors of the company deducting the loss or outgoing.

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1 *Income Tax Assessment Act 1997* (Cth) ss 26-45, 26-50.

2 *Income Tax Assessment Act 1997* (Cth) ss 26-45(3), 26-50(8).

3 "Company" is defined in *Income Tax Assessment Act 1997* (Cth) s 995-1 as including all bodies or associations corporate or unincorporated, but not partnerships.

4 *Income Tax Assessment Act 1997* (Cth) s 126-45(2).

5 *Income Tax Assessment Act 1997* (Cth) s 126-50(2) (definitions "leisure facility").

[31.4.1930] Expenditure incurred in the provision of entertainment is not allowable as a deduction.[1] Part 2-5 Div 32 of the *Income Tax Assessment Act 1997* (Cth) contains a comprehensive regime for denying deductions for a wide range of entertainment expenditure. Section 32-10 defines "entertainment", a concept which is the foundation of Pt 2-5 Div 32, as including entertainment by way of food, drink or recreation; and accommodation or travel in connection with entertainment. This is irrespective of whether business transactions occur during the entertainment or travel, whether it occurred in connection with the working of overtime in performing duties under an office or employment, whether it occurred for the purposes of promotion or advertising or whether it occurred in connection with a seminar.[2]

The operative provision is s 32-5, which denies a deduction for losses or outgoings incurred in respect of providing entertainment, unless one of the exceptions under Pt 2-5 Div 32 Subdiv 32-B applies. Part 2-5 Div 32 Subdiv 32-B contains an important group of exceptions to this non-deductibility rule. The main exception is that expenditure is deductible under Pt 2-5 Div 32 Subdiv 32-B where it is incurred in respect of providing entertainment by way of providing a "fringe benefit", as defined by s 136(1) of the *Fringe Benefits Tax Assessment Act 1986* (Cth).[3] Expenditure is deductible under Pt 2-5 Div 32 Subdiv 32-B where any of the following criteria are satisfied:

(1) a taxpayer carries on the business of providing entertainment to customers for payment and the loss or outgoing is incurred in the ordinary course of that business in providing that entertainment;

(2) the loss or outgoing is incurred in supplying entertainment under a contract to do so in the ordinary course of business where it has been provided in order to promote or advertise to the public a business conducted by the taxpayer or goods or services provided by a business of the taxpayer;

(3) the loss or outgoing is incurred in promoting or advertising to the public goods or services provided by a business conducted by the taxpayer and was incurred in providing or exhibiting those goods or services to the public;

(4) the loss or outgoing is incurred in providing entertainment for the purpose of promoting or advertising to the public either the taxpayer's business, another person's business or goods or services provided by a business carried on by the taxpayer or by another person, on the basis that the opportunities available to some people to obtain the benefits of the entertainment are not greater than those of ordinary members of the public;

(5) the loss or outgoing is incurred in providing an allowance to an employee which has been included in the employee's assessable income;

(6) the loss or outgoing is incurred in providing food and drink to employees of the taxpayer or of an associated company of the taxpayer in an in-house dining facility[4] or in a dining facility to employees of the taxpayer where the person performs most of their duties in connection with the dining facility,[5] or the provision of entertainment that is reasonably incidental to a person's attendance at an eligible seminar that goes for at least four hours;[6]

(7) the loss or outgoing is incurred in providing a facility for recreation on property that is occupied by the taxpayer, if the facility is mainly operated for the use of the taxpayer's employees;[7]

(8) the loss or outgoing is incurred in providing entertainment for the taxpayer, an employee of the taxpayer, or for a person performing services for the taxpayer who is not employed by the taxpayer, where a deduction would have been allowable under former s 51(1) of the *Income Tax Assessment Act 1936* (Cth) had it been incurred by the recipient of the entertainment or where it could be concluded that the purpose of incurring the expenditure was to provide or facilitate the provision of entertainment to a person other than the taxpayer;

(9) the loss or outgoing is incurred in providing food or drink to the taxpayer's employee under an industrial instrument relating to overtime;[8]

(10) a taxpayer is an employee and incurs a loss or outgoing to buy food or drink to do with overtime that the taxpayer works, if the taxpayer received an allowance under an industrial instrument to buy the food or drink;[9] or

(11) the loss or outgoing is incurred in providing gratuitous entertainment to members of the public who are sick, disabled, poor or otherwise disadvantaged.[10]

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1 *Income Tax Assessment Act 1997* (Cth) s 32-5.

2 There is no statutory definition of "entertainment", therefore the word carries its ordinary meaning. In Australian Taxation Office, *Income Tax and Fringe Benefits Tax: Entertainment by Way of Food or Drink*, TR 97/17, 30 July 1997, the Commissioner of Taxation accepts that morning and afternoon tea provided to employees and light meals are not entertainment: see [31.4.380]. The ruling contains a thorough analysis of case law on the meaning of the word.

3 *Income Tax Assessment Act 1997* (Cth) ss 32-20, 32-40.

4 *Income Tax Assessment Act 1997* (Cth) s 32-30 Table Item 1.1. However, the exception is not available where the food or drink is provided at a party, reception or other social function. See also *Income Tax Assessment Act 1997* (Cth) s 32-45 Table Item 4.1.

5 *Income Tax Assessment Act 1997* (Cth) s 32-30 Table Item 1.3. However, the exception is not available where the food or drink is provided at a party, reception or other social function. See also *Income Tax Assessment Act 1997* (Cth) s 32-45 Table Item 4.2.

6 *Income Tax Assessment Act 1997* (Cth) s 32-35. However, the exception is not available where the seminar is a business meeting, its main purpose is to provide entertainment in connection with the seminar or to promote or advertise a business, its goods or its services.

7 *Income Tax Assessment Act 1997* (Cth) s 32-30 Table Item 1.5. However, the exception is not available where the facility is for accommodation or dining or drinking, other than in the case of a vending machine. See also *Income Tax Assessment Act 1997* (Cth), s 32-25 Table Item 1.8.

8 *Income Tax Assessment Act 1997* (Cth) s 32-30 Table Item 1.4.

9 *Income Tax Assessment Act 1997* (Cth) s 32-50 Table Item 5.1.

10 *Income Tax Assessment Act 1997* (Cth) s 32-50 Table Item 5.2.

[31.4.1940] Travel expenses of an accompanying relative are not deductible to a taxpayer.[1] Section 26-30 of the *Income Tax Assessment Act 1997* (Cth) denies a deduction for expenses attributable to an accompanying relative where a person, while undertaking travel in the course of performing duties for an employer or a business for the purpose of gaining or earning assessable income, is accompanied by a relative of the person, provided the relative is not an employee of the person's employer (the "fellow employee" exception). However, the "fellow employee" exception does not apply if the relative is an employee but performs no duties during that period for the employer, or if the relative is an employee and the duties performed during that period were incidental to the duties of the person and it is reasonable to conclude that but for the personal relationship between the relative and the person the relative would not have accompanied the person during that period. The deduction is denied to the person undertaking the travel and/or the person's employer. The one exception to the denial of the deduction is where the expenditure was incurred by the provider of a fringe benefit within the meaning of the *Fringe Benefits Tax Assessment Act 1986* (Cth).[2] Section 26-30 also applies to individuals who are not employees and to entities which are not employers where the individual receives withholding payments or the entity makes withholding payments covered by Sch 1 ss 12-40, 12-45, 12-50 and Sch 1 Pt 2-5 Div 12 Subidv 12-D to the *Taxation Administration Act 1953* (Cth).

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1 *Income Tax Assessment Act 1997* (Cth) s 26-30.
2 *Income Tax Assessment Act 1997* (Cth) s 26-30(3).

[31.4.1950] Expenses which are otherwise deductible to an employee are disallowed to the extent that they are reimbursed.[1] Section 51AH of the *Income Tax Assessment Act 1936* (Cth) provides that expenses incurred by an employee are not deductible by the employee to the extent that they are reimbursed and constitute a fringe benefit. The reimbursement in such a case would constitute exempt income under s 23L. The provision does not apply where a person is reimbursed for car expenses under s 15-70 of the *Income Tax Assessment Act 1997* (Cth).

However, if the reimbursement by the employer would have been the same even if the employee's expense had not been incurred in producing assessable income (ie it is not a direct expense reimbursement) then the deduction allowable to the employee is calculated on the basis that would apply if the employee had incurred expenditure equal to the net amount incurred. This is consistent with the manner in which fringe benefits tax is reduced to the extent that expenditure would otherwise be deductible to the employee.

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1 *Income Tax Assessment Act 1936* (Cth) s 51AH.

[31.4.1960] Section 51AJ of the *Income Tax Assessment Act 1936* (Cth) denies a deduction for the private component of contributions by employees to the cost to the employer of providing fringe benefits. Section 51AJ complements s 51AF by ensuring that an employee is not entitled to a tax deduction for a contribution to a fringe benefit to the extent that the contribution is, in effect, a payment for the private element of the benefit. This measure applies to airline transport fringe benefits, board fringe benefits, loan fringe benefits, property fringe benefits or residual fringe benefits as defined by the *Fringe Benefits Tax Assessment Act 1986* (Cth).

[31.4.1970] Part 2-5 Div 34 of the *Income Tax Assessment Act 1997* (Cth) denies a deduction for expenditure by an employee incurred in connection with a non-compulsory uniform or wardrobe for work use unless certain conditions are satisfied.[1] Section 34-10 allows a deduction for non-compulsory uniform/wardrobe expense if the expenditure has been incurred on clothing complying with designs entered in the Register of Approved Occupational Clothing and the expenditure would have otherwise been deductible under another provision of the *Income Tax Assessment Act 1997*. Section 34-15(1) defines "uniform" as items of clothing which, when considered as a set, distinctively identify the wearer as a person associated, directly or indirectly, with the employer or an associate of the employer within the meaning of s 318 of the *Income Tax Assessment Act 1936* (Cth). A uniform is taken to be non-compulsory unless the employer consistently enforces a policy that requires all employees who do the same type of work to wear the uniform when working for the employer, and the policy prohibits employees from substituting an item of clothing not included in the uniform for an item of clothing included in the uniform.

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1 *Income Tax Assessment Act 1997* (Cth) s 34-10(2).

[31.4.1980] Outgoings incurred in making payments to persons associated with the taxpayer may be partly or wholly disallowed as deductions.[1] Sections 26-35 and 26-40 of the *Income Tax Assessment Act 1997* (Cth) provide that the amount of any payment made or liability incurred in the year of income by a taxpayer to a related entity that would otherwise be an allowable deduction is allowable as a deduction only to the extent to which, in the opinion of the Commissioner of Taxation, the payment was reasonable. Sections 26-35(2) defines "related entity" to mean a relative of the taxpayer or a partnership in which the relative of the taxpayer is a partner. Sections 26-40 provides that expenditure incurred for the maintenance of the taxpayer's spouse or children less than 16-years-old shall not be an allowable deduction.

Section 109 provides that where a private company[2] pays or credits an amount to an associated person[3] which is remuneration for services rendered by the associated person or an allowance, gratuity or compensation in consequence of the retirement of the associated person from an office or employment or upon the termination of that office or employment, then that proportion of the amount paid which exceeds an amount that, in the Commissioner's opinion, is reasonable, is not allowable as a deduction. Furthermore, the amount is deemed to be a dividend paid by the company to the associated person as a shareholder in the company[4] out of profits by the company[5] and is deemed to have been paid on the last day of the year of income in which the payment was made.[6]

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1 *Income Tax Assessment Act 1936* (Cth) s 109; *Income Tax Assessment Act 1997* (Cth) ss 26-35, 26-40.

2 *Income Tax Assessment Act 1936* (Cth) s 103A(1) defines "private company" as any company which is not a public company. Section 103A(2) defines "public company" as being a company whose shares are listed on a stock exchange, a co-operative company, a non-profit company, a mutual life company, a friendly society, a government instrumentality and a subsidiary of a public company (being a public company under one of the preceding limbs of the definition).

3 *Income Tax Assessment Act 1936* (Cth) s 109(2)(b) defines "associated person" as being a shareholder in, or director of, or former shareholder in, or former director of, a company or a person who is an associate (within the meaning of the broad definition contained in s 318) of a shareholder in, or director of, or former shareholder in, the company.

4 That is, the associated person is deemed to be a shareholder of the company for the purpose of imputing the receipt of the deemed dividend to that person.

5 That is, the payment need not actually be sourced in profits as *Income Tax Assessment Act 1936* (Cth), s 109 deems that to have been the source. This deeming is necessary as only dividends sourced in profits are characterised as assessable income by s 44.

6 *Income Tax Assessment Act 1936* (Cth) s 109(1)(d).

Substantiation of Expenses

General

[31.4.1990] Individuals are required to create and retain certain records in order to be entitled to claim deductions for car expenses, travel expenses and other work-related outgoings. These rules, known as the substantiation rules, are contained in Pt 2-5 Div 28 and Pt 5-30 Div 900 of the *Income Tax Assessment Act 1997* (Cth).

The effect of the substantiation rules is that although a taxpayer may have fulfilled the technical requirements for claiming a deduction, the deduction is denied unless the taxpayer can prove that the substantiation provisions have been satisfied.

The substantiation rules only apply to a taxpayer who is either an individual or a partnership that includes at least one individual. They do not apply to corporations, partnerships of corporations or trusts. Documents supporting claims must be produced to the Commissioner of Taxation when required by notice in writing. The notice must specify the time within which the documents must be produced, being not less than 28 days.[1] The documentary evidence must be supported by a schedule in English which gives a cross reference to and a summary of the particulars. Failure to produce the documents may result in the deductions being disallowed.[2] All documents supporting claims must be retained for five years.[3]

The Commissioner does have an overriding discretion to grant relief from strict compliance with the rules.[4] Relief is available where the nature and quality of the evidence available satisfies the Commissioner that the taxpayer incurred the expense and that a deduction is allowable for the amount claimed.[5] Relief is also available if the taxpayer had a reasonable expectation that substantiation would not be required.[6] The availability of this relief, viewed in light of the willingness of the Administrative Appeals Tribunal to grant relief under the former, narrower relief provision, suggests that a failure to comply strictly with the substantiation provisions does not lead to denial of a deduction provided there is reasonable evidence that the expense was incurred.

Taxpayers who are earning income from salary and wages may potentially have to comply with the substantiation rules applicable to work expenses, business travel and car expenses. Self-employed taxpayers do not have to comply with the substantiation rules for work expenses but may be subject to the substantiation rules for car expenses and business travel.[7]

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1 *Income Tax Assessment Act 1997* (Cth) s 900-175.

2 *Income Tax Assessment Act 1997* (Cth) s 900-185.

3 *Income Tax Assessment Act 1997* (Cth) ss 900-25, 900-75, 900-90. See also “Access to Information” [31.12.1380]–[31.12.1770].

4 *Income Tax Assessment Act 1997* (Cth) s 900-195.

5 *Income Tax Assessment Act 1997* (Cth) s 900-195. Australian Taxation Office, *Income Tax: Relief from the Effects of Failing to Substantiate*, TR 97/24, 3 December 1997, explains the operation of *Income Tax Assessment Act 1997* (Cth) Pt 5-30 Div 900 Subdiv 900-H. It states that it will be a question of fact and degree as to whether the evidence provided satisfies criteria under s 900-195. Australian Taxation Office, *Practice Statement Law Administration: Substantiating an Individual’s*

Work-related Expenses, PS LA 2005/7, 20 April 2005 provides further guidance about the quality and nature of evidence that the Commissioner will accept in exercising a discretion under Pt 5-30 Div 900 Subdiv 900-H.

6 *Income Tax Assessment Act 1997* (Cth) s 900-200.

7 See *AAT Case 9918* (1994) 30 ATR 1041 (AAT).

Car Expenses

[31.4.2000] Outgoings associated with operating a car must be substantiated. In order to be deductible under s 8-1 of the *Income Tax Assessment Act 1997* (Cth), outgoings which are car expenses must be substantiated by using one of two methods: see [31.4.2020]–[31.4.2050]. "Car expense" is defined as an expense to do with a car, including an expense to do with operating a car and depreciation of a car but does not include expenses incurred in respect of travel outside Australia or taxi fares and like expenses.[1] Section 995-1(1) of the *Income Tax Assessment Act 1997* (Cth) defines "car" to mean any motor vehicle other than a motorcycle or similar vehicle designed to carry a load of less than 1 tonne and fewer than nine passengers.

A taxpayer is not bound to use the same method each year and may switch from one method to the other. If the taxpayer has more than one car different methods may be used within the same year for each car.[2]

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1 *Income Tax Assessment Act 1997* (Cth) s 28-13.

2 *Income Tax Assessment Act 1997* (Cth) ss 28-15, 28-20.

[31.4.2010] The rules for substantiating expenses are set out in Pt 2-5 Div 28 Subdiv 28-I of the *Income Tax Assessment Act 1997* (Cth): see [31.4.2060]. Fuel and oil expenses are substantiated by using odometer records to make a reasonable estimate based on kilometres travelled, average fuel costs and average fuel consumption (eg based on Bureau of Statistics figures, the *Green Vehicle Guide*[1] and the *Australian Fuel Consumption Guide*).[2]

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1 For vehicle models sold from 2004 onwards, see <https://www.greenvehicleguide.gov.au> .

2 For vehicles sold between 1986 and 2003, see <http://www.environment.gov.au/settlements/transport/fuelguide/search.html>. See also Australian Taxation Office, *Income Tax: Substantiation: Car Expenses: How Do You Calculate the Cost of Fuel and Oil when Using the "One-third of Actual Expenses" Method or the "Log Book" Method, if You Have Not Kept Written Evidence of the Expense?*, TD 97/19, 30 July 1997.

[31.4.2020] The first method of substantiating car expenses is known as the "cents per kilometre" method. This method is only available for cars for up to 5,000 business kilometres. "Business kilometres" refers to the distance travelled in the course of producing assessable income, or during your travel between workplaces.[1] The deduction is calculated by multiplying the business kilometres the car travelled (up to a maximum of 5,000) by the number of cents per kilometre for the car.[2] It is not necessary to substantiate the number of kilometres travelled by creating and retaining special records. The taxpayer is permitted to rely upon a reasonable estimate of the number of business kilometres.[3]

1 *Income Tax Assessment Act 1997* (Cth) s 28-25(3).
2 *Income Tax Assessment Act 1997* (Cth) s 28-25(1).
3 *Income Tax Assessment Act 1997* (Cth) s 28-35.

[31.4.2050] The second method of substantiating car expenses is known as the "log book" method. Under this method a deduction is calculated by multiplying each deductible car expense by a business use percentage based on a reasonable estimate of the number of business kilometres.[1] A prerequisite for adopting this method is that the taxpayer must "hold" the car for some or all of the year of income.[2] A taxpayer "holds" a car while she or he owns it, or leases it for use in the course of producing assessable income even if it is also used for some other purpose.[3]

Business kilometres are determined by making a reasonable estimate, which must take into account all relevant matters including log books, odometer records, variations in the pattern of use of the car and any changes in the number of cars used for income-producing purposes during the year.[4] It is necessary to substantiate the expenses in accordance with the rules in Pt 5-30 Div 900 Subdiv 900-C of the *Income Tax Assessment Act 1997* (Cth) (see [31.4.2060]) and keep a log book and odometer records.[5]

A "log book" is a log book or similar document in which is recorded in respect of each business trip during the applicable log book period undertaken in the course of producing assessable income, an entry showing the date the journey began and the date it ended, odometer readings at the start and end of each journey, the number of kilometres travelled and the purpose of the journey.[6] If two or more journeys are undertaken on one day they may be recorded as a single journey.[7] The log book must also record the following:

(1) when the log book period begins and ends;

(2) odometer readings at the start and end of the period;

(3) total kilometres travelled during the period;

(4) total business kilometres travelled on recorded journeys during the period; and

(5) the business percentage of travel during the period.[8] For the first year in which car expenses are claimed under the log book method, a log book need only be kept for a continuous period of 12 weeks.[9]

A taxpayer may select any 12-week period if she or he may be at a disadvantage by selecting another period, although variations in patterns of use must still be considered in making the estimate, and the log book may be kept for longer than 12 weeks if desired. In the four years succeeding the year in which the log book was kept the taxpayer may apply the proportion of business use determined from the 12-week period in which the log book was kept. However, a new log book is required to be kept after five years or if required by the Commissioner by notice before a year commences.[10]

A taxpayer may nominate a car as a replacement for an existing car from a specified date. The nomination must be recorded in writing before lodgment of the return for the year in which the replacement takes effect, although the Commissioner has a discretion to extend that time.[11]

From the date specified the replacement car is treated as the original car having been continuously owned and the log books kept for the original vehicle need not be replaced.[12]

"Odometer records" are defined as a document which records for the period for which a car was owned or leased for use in income-producing purposes during an income year the odometer reading at the start and end of the period; the make, model registration number and engine capacity of the car; the make, model registration number and engine capacity of any nominated replacement car; and odometer readings of both cars as at the end of the nominated replacement day.[13]

Entries for odometer readings must be made in English as soon as possible after the start and end of the relevant period (or as soon as possible after the end of the replacement day if a replacement occurs).[14] However, the Commissioner has a discretion to permit a late entry in both cases.[15]

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1 *Income Tax Assessment Act 1997* (Cth) s 28-90.
2 *Income Tax Assessment Act 1997* (Cth) s 28-95.
3 *Income Tax Assessment Act 1997* (Cth) s 28-90(6).
4 *Income Tax Assessment Act 1997* (Cth) s 28-90(5).
5 *Income Tax Assessment Act 1997* (Cth) s 28-100.
6 *Income Tax Assessment Act 1997* (Cth) s 28-125(2).
7 *Income Tax Assessment Act 1997* (Cth) s 28-125(3).
8 *Income Tax Assessment Act 1997* (Cth) s 28-125(4).
9 *Income Tax Assessment Act 1997* (Cth) s 28-120.
10 *Income Tax Assessment Act 1997* (Cth) s 28-115.
11 *Income Tax Assessment Act 1997* (Cth) s 28-130(3).
12 *Income Tax Assessment Act 1997* (Cth) s 28-130(1), (2).
13 *Income Tax Assessment Act 1997* (Cth) s 28-140.
14 *Income Tax Assessment Act 1997* (Cth) s 28-140(2), (4).
15 *Income Tax Assessment Act 1997* (Cth) s 28-140(5).

[31.4.2060] In a number of situations taxpayers are exempt from the substantiation requirements in respect of car expenses. The exemptions apply:[1]

(1) where the car is provided for the exclusive use of employees or relatives and was subject to fringe benefits tax;[2]

(2) where the car is hired or leased in the course of carrying on a business of hiring or leasing cars;[3]

(3) during the period when a taxpayer owned or leased a car for use in producing assessable income, it was used principally for that purpose and it was unregistered;[4]

(4) where the car was part of the trading stock of a business of selling cars carried on by a taxpayer and he or she used it in the course of that business;[5]

(5) where the expense is to do with repairs or other work on the car and the taxpayer incurred it in his or her business of doing repairs or other work on cars; and[6]

(6) where the car was a panel van, a utility, a taxi or like vehicle and the taxpayer used the car only:

(a) for travel in the course of producing assessable income;[7] and/or

(b) for travel that is incidental to (a); and/or

(c) by providing the car to someone else for travel between his or her residence and place of work; and/or

(d) for minor infrequent and irregular private travel by the taxpayer or someone else.[8]

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1 *Income Tax Assessment Act 1997* (Cth) ss 28-170, 28-175.
2 *Income Tax Assessment Act 1997* (Cth) s 28-170(3) Table Item 4.
3 *Income Tax Assessment Act 1997* (Cth) s 28-170(3) Table Item 3.
4 *Income Tax Assessment Act 1997* (Cth) s 28-175(3)(a).
5 *Income Tax Assessment Act 1997* (Cth) s 28-170(3) Table Item 2.
6 *Income Tax Assessment Act 1997* (Cth) s 28-175(3)(c).
7 *Income Tax Assessment Act 1997* (Cth) s 28-170(3) Table Item 1.
8 *Income Tax Assessment Act 1997* (Cth) s 28-170(3) Table Item 1.

Work Expenses

[31.4.2070] Outgoings incurred in deriving wage and salary income must be substantiated. Outgoings which are work expenses are not deductible unless the taxpayer retains certain records. A "work expense" is defined as an expense incurred in producing salary or wages and includes accommodation expenses, meal expenses and other expenses incidental to travel which are intended to be met out of a travel allowance or a meal allowance.[1] The definition excludes car expenses. To deduct a work expense it must qualify for a deduction under a provision of the *Income Tax Assessment Act 1936* (Cth) or the *Income Tax Assessment Act 1997* (Cth).

A work expense is only deductible if a taxpayer substantiates it by written evidence as specified in Pt 5-30 Div 900 Subdiv 900-E of the *Income Tax Assessment Act 1997* (Cth).[2] The evidence required for expenses other than depreciation comprises a receipt, invoice or similar document obtained from the supplier of the goods or services that sets out the name or business name of the supplier; the amount of the expense; the nature of the goods or services; the date the expense was incurred; and the date of the document. Credit card receipts may be acceptable if the receipt contains all the above particulars.[3] If the receipt does not specify the nature of the goods or services the taxpayer may add the required details to the document before lodgement of the tax return for the year to which the deduction relates.[4] If the document does not show the date the expense was incurred, supporting evidence of the date of payment such as a bank statement or other independent evidence, may be used.[5] Similar rules apply to depreciation expenses. The documentary evidence comprises a receipt, invoice or similar document obtained from the supplier that sets out the name or business name of the vendor or supplier, the cost of the property, the nature of the property, the date the property was acquired and the date on which the document is prepared.[6]

1 *Income Tax Assessment Act 1997* (Cth) s 900-30.
2 *Income Tax Assessment Act 1997* (Cth) s 900-15.
3 See Australian Taxation Office, *Income Tax: Credit Card Receipts: Documentary Evidence Required to Substantiate Certain Expenses*, IT 2482, 30 June 1988, which applied to the former provisions. Credit card documents also suffice if, though not complete, they contain sufficient information to clearly identify the goods or services: see Australian Taxation Office, *Income Tax: Relief from the Effects of Failing to Substantiate, Taxation Ruling TR 97/24*, 3 December 1997.
4 *Income Tax Assessment Act 1997* (Cth) s 900-115(3)(b).
5 *Income Tax Assessment Act 1997* (Cth) s 900-115(3)(a).
6 *Income Tax Assessment Act 1997* (Cth) s 900-120.

[31.4.2080] There are a number of exceptions to the requirement that, in order to be deductible, work expenses must be substantiated. The general documentary evidence requirements do not apply to two categories of small or undocumentable expenses. First, expenses that individually do not exceed $10 where the total of these expenses does not exceed $200 for the year of income,[1] and second, where the Commissioner of Taxation considers that it would be unreasonable to expect the taxpayer to have obtained documentary evidence of the expense.[2]

A further exception applies where a taxpayer's total work expenses are less than $300. Where this condition is satisfied documents are not required to be retained.[3] Car expenses cannot be excluded under this exemption and are not counted in the $300 total. If the $300 limit is exceeded by even $1 the total of the expenses must then be substantiated.[4] Laundry expenses are subject to a further concession. Although such expenses count towards determining whether the $300 limit for work expenses has been breached, s 900-40 of the *Income Tax Assessment Act 1997* (Cth) allows laundry expenses up to $150 to be claimed as a deduction without substantiation even if the total $300 limit for work expenses is exceeded. A "laundry expense" is defined as a work expense to do with washing, drying or ironing clothes, but excludes dry cleaning.[5]

An important exception to the substantiation rules applies to employees in receipt of a domestic travel allowance. The exception applies if an employee incurs travel expenses which are work expenses, the employee is in receipt of a travel allowance which is designed to cover those expenses and the total amount claimed is considered reasonable by the Commissioner.[6] A "travel allowance" is defined as an allowance paid by an employer to cover expenses of accommodation, food, drink or expenses incidental to the travel which are incurred by the employee in travel away from the employee's ordinary residence and undertaken in the course of her or his duties as an employee.[7] Allowances paid to cover travel which do not involve staying away from home overnight are therefore not covered by the exception.[8]

A narrower exemption is also available for travel outside Australia. If the allowance is paid to cover the cost of overseas travel the exception does not apply to accommodation expenses, which must be substantiated. It is also necessary to keep a travel diary: see [31.4.2090]. The Commissioner issues a determination annually setting out the amounts that the Commissioner considers are reasonable for the relevant allowances.[9]

A further exception applies to employees claiming expenses against transport allowances or reimbursements not exceeding the amount set by or determined in accordance with an applicable award in place on 29 October 1986.[10] Such expenses do not require substantiation by either written evidence or travel records. Such expenses do not count towards the $300 limit for total work expenses which can be claimed without substantiation.[11]

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1 *Income Tax Assessment Act 1997* (Cth) s 900-125.
2 *Income Tax Assessment Act 1997* (Cth) s 900-130.
3 *Income Tax Assessment Act 1997* (Cth) s 900-35.
4 *Income Tax Assessment Act 1997* (Cth) s 900-35(1).
5 *Income Tax Assessment Act 1997* (Cth) s 900-40(4).
6 *Income Tax Assessment Act 1997* (Cth) s 900-50.
7 *Income Tax Assessment Act 1997* (Cth) s 900-30(3).
8 See Australian Taxation Office, *Income Tax: What Are the Reasonable Travel and Overtime Meal Allowance Expense Amounts for the 2012–13 Income Year?*, TD 2012/17, 27 June 2012, for the Commissioner's determination for the 2012–2013 income year.
9 See Australian Taxation Office, *Income Tax: What Are the Reasonable Travel and Overtime Meal Allowance Expense Amounts for the 2012–13 Income Year?*, TD 2012/17, 27 June 2012.
10 *Income Tax Assessment Act 1997* (Cth) s 900-45.
11 *Income Tax Assessment Act 1997* (Cth) ss 900-35(3), 900-245.

Business Travel Expenses

[31.4.2090] A taxpayer is required to substantiate outgoings incurred in the course of business travel. A taxpayer must substantiate a business travel expense by obtaining written evidence in accordance with Pt 5-30 Div 900 Subdiv 900-E of the *Income Tax Assessment Act 1997* (Cth).[1] "Business travel expense" is defined as a travel expense insofar as it is incurred in producing assessable income other than salary and wages, and excludes car expenses.[2] A "travel expense" is an expense incurred in travel that involves the taxpayer being away from his or her ordinary residence for at least one night within or outside Australia.[3] There is no overlap between business travel expenses on the one hand and work expenses and car expenses on the other. This also means that the substantiation rules do not apply to travel expenses incurred in earning non-salary and wage income which do not involve an absence of at least one night from home. Travel expenses which are intended to be covered by a travel allowance must be substantiated in accordance with the rules for work expenses. They are not covered by the business travel rules: see [31.4.2070]–[31.4.2080].

To claim a business travel expense it must be substantiated by documentary evidence. In addition, a travel diary is required if the travel involves an absence from home for six or more consecutive nights.[4] A travel diary is a record of activities undertaken in the course of business travel. An activity is recorded by specifying in the diary the nature of the activity, the day and approximate time it began, how long it lasted and where it occurred.[5] The activity must be recorded before it ends or as soon as possible thereafter.[6] If an activity is not recorded it cannot be taken into account in determining the proportion of the expenditure which is deductible.[7]

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1 *Income Tax Assessment Act 1997* (Cth) s 900-80(1).

2 *Income Tax Assessment Act 1997* (Cth) s 900-95(1).
3 *Income Tax Assessment Act 1997* (Cth) s 900-95(2).
4 *Income Tax Assessment Act 1997* (Cth) ss 900-80, 900-85.
5 *Income Tax Assessment Act 1997* (Cth) s 900-150(1).
6 *Income Tax Assessment Act 1997* (Cth) s 900-150(2).
7 *Income Tax Assessment Act 1997* (Cth) s 900-155.

35

Unfair Dealing

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Unfair Dealing

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35.10 Table of Contents

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Introduction

Definition

[35.10.10] The law against penalties and relief against forfeiture are remedies that a court may grant a defaulting party. The definition of "penalty" and the test to determine whether or not a contractual term is a penalty, have evolved significantly since the original description in *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd* [1915] AC 79. Though the remedy has its origins in equity, there is some dispute about whether the equitable doctrine against remedies has been completely overridden by the common law rule against penalties.[1]

Conversely, relief against forfeiture remains an equitable remedy. While the rule against penalties invalidates a term or terms of the contract, relief against forfeiture is a remedy whereby an innocent party is estopped from relying on a valid right to terminate.[2] This remedy has been reduced to statute in certain circumstances involving landlords and tenants, and hence can differ slightly between jurisdictions.

1 *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 90 ALJR 835; [2016] HCA 28, [122] (Gageler J), referring to *Citicorp Australia Ltd v Hendry* (1985) 4 NSWLR 1, 39–40 (Priestley JA).

2 *Tanwar Enterprises Pty Ltd v Cauchi* (2003) 217 CLR 315; 77 ALJR 1853; [2003] HCA 57, [2] [19], [57]–[60] (Gleeson CJ, McHugh, Gummow, Hayne and Heydon JJ).

Scope of Subtitle

[35.10.20] This Subtitle deals with the relief available under both common law and equity to defaulting parties to a contract. This relief includes:

(1) the law against penalties (see [35.10.140]–[35.10.180]);

(2) relief against forfeiture generally (see [35.10.190]–[35.10.200]);

(3) relief against forfeiture in the case of the sale of land (see [35.10.210]); and

(4) relief against forfeiture in lease disputes: see [35.10.220]–[35.10.250].

This Subtitle deals with the rule against penalties in all types of contracts. Though, the most recent high profile cases have been associated with the financial sector, and the provision of retail deposit accounts and consumer credit.[1]

Relief against forfeiture is primarily used in contracts involving either the sale or lease of land. In disputes relating to the sale of land, the court will examine the actions of each of the parties and the consequences for each party as a result of the breach before determining whether to intervene.

In lease disputes, this Subtitle differentiates between disputes arising from the non-payment of rent, and disputes arising from other breaches by the lessee. In cases of non-payment of rent, historically the power of the court to relieve against forfeiture was within the inherent power of the Courts of Chancery for some centuries. Only comparatively recently has this power been specifically granted to the State Supreme Courts via statute.

In disputes other than those caused by non-payment of rent, the court's power to grant relief against forfeiture has been created by statute specific to each State, resulting in different requirements depending on the jurisdiction.

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1 *Andrews v Australia & New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002; 6 BFRA 211; [2012] HCA 30; *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 90 ALJR 835; [2016] HCA 28.

Related Titles and Subtitles

[35.10.30] The equitable concept of penalties and relief against forfeiture is related to many other areas of the law. Within 7 *Contract: General Principles*, the most relevant Subtitles are "Breach" [7.6.10]ff and "Remedies" [7.9.10]ff. The Title 15 *Equity* deals with different forms of relief against equity, and "Rescission" [15.7.10]ff and "Delivery Up, Cancellation and Rectification" [15.12.10]ff would be of most assistance. As relief against forfeiture is a doctrine often applied in cases involving the sale or rental of land, 28 *Real Property* is particularly relevant, and specific Subtitles include "Landlord and Tenant" [28.7.10]ff, "Retail Tenancies" [28.8.10]ff and "Sale of Land" [28.18.10]ff.

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Penalties and Forfeiture

[35.10.140] The term "penalty" has been defined by the High Court as a punishment. In *Andrews v Australia & New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002; 6 BFRA 211; [2012] HCA 30, the High Court defined "penalty" as consisting of the imposition of an additional or different contractual liability on a party that is dependent on the non-observance of a "primary" contractual stipulation.[1]

This definition was drawn from the original description of a penalty as "a payment of money stipulated as in terrorem of the offending party" by Lord Dunedin in *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd* [1915] AC 79.[2] However, describing a penalty as a term that "terrorises a party" has been found not especially helpful, as the court has protected defaulting parties who readily agreed to pay such penalties at the contract's outset.[3]

Essentially, two characteristics of a penalty are "threat and punishment". When the sum required to be paid by the breaching party upon default could be considered a direct threat against the defaulting party, or the sum could be considered a punishment inflicted upon the defaulting party for its breach, the term requiring the payment of such a sum is considered a penalty.[4]

If a term in a contract is found to be a penalty, it is unenforceable. The principle is that though an innocent party may have an interest in ensuring the defaulting party performs their primary obligation, it has no interest in punishing that defaulting party for its default.[5]

As a result, the role of the court is to draw a distinction between a valid term of a contract that implements a burden on the defaulting party to compensate the innocent party for its loss incurred, and a penalty clause.

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1 *Andrews v Australia & New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002; 6 BFRA 211; [2012] HCA 30, [9] (the Court), referring to *Legione v Hateley* (1983) 152 CLR 406; 57 ALJR 292, 445 (Mason and Deane JJ) (CLR).

2 *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd* [1915] AC 79, 86–87 (Lord Dunedin); *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656; 80 ALJR 219; [2005] HCA 71, [11] (the Court); *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 90 ALJR 835; [2016] HCA 28, [260] (Keane J).

3 *Bridge v Campbell Discount Co Ltd* [1962] AC 600; [1962] 2 WLR 439, 622 (Lord Radcliffe) (AC); *Cavendish Square Holding BV v Makdessi* [2016] AC 1172; [2015] 3 WLR 1373; [2015] UKSC 67, [140] (Lord Mance); *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 90 ALJR 835; [2016] HCA 28, [258] (Keane J); *Robophone Facilities Ltd v Blank* [1966] 1 WLR 1428, 1446 (Diplock LJ).

4 *Bridge v Campbell Discount Co Ltd* [1962] AC 600; [1962] 2 WLR 439, 622 (Lord Radcliffe) (AC); *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 90 ALJR 835; [2016] HCA 28, [17] (Kiefel J).

5 *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 90 ALJR 835; [2016] HCA 28, [22] (Kiefel J), referring to *Legione v Hateley* (1983) 152 CLR 406; 57 ALJR 292, 445 (Mason and

Deane JJ) (CLR); *Andrews v Australia & New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002; 6 BFRA 211; [2012] HCA 30, [9]–[10] (the Court); *Cavendish Square Holding BV v Makdessi* [2016] AC 1172; [2015] 3 WLR 1373; [2015] UKSC 67, [31]–[32] (Lord Neuberger and Lord Sumption (Lord Carnwath agreeing)).

[35.10.150] When determining whether or not a term is a penalty, a number of questions must be asked. The first question is what, if any, interest of the innocent party is protected by the clause, and whether the sum agreed upon is comparable to the loss the innocent party will suffer should the contract be breached.[1]

Interests considered capable of protection by a clause in a contract include:

(1) Preventing a secondary supplier from undercutting the primary manufacturer's sale price.[2]

(2) Ensuring that a fleet of torpedo boats are completed in time.[3]

(3) Maintaining the goodwill of a business.[4]

(4) The costs of ensuring late payments were made, as well as the increase in loss provisions and an increase in the costs of regulatory capital due to a customer's late payments.[5]

To decide whether the sum specified is comparable to the loss suffered by the innocent party, the court must determine what "damage" the innocent party has suffered as a result of the breach. If the contract is merely for the payment of a certain amount of money, determining damage is very simple.[6] However, where the "damage" is not easily determined, the court must make a determination based on the circumstances of the case.[7] This is dealt with further at [35.10.170].

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1 *Clydebank Engineering & Shipbuilding Co Ltd v Don Jose Ramos Yzquierdo y Castaneda* [1905] AC 6, 19–20 (Lord Robertson); *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 90 ALJR 835; [2016] HCA 28, [137] (Gageler J); *Cavendish Square Holding BV v Makdessi* [2016] AC 1172; [2015] 3 WLR 1373; [2015] UKSC 67; *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656; 80 ALJR 219; [2005] HCA 71, [31]–[32] (the Court).

2 *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd* [1915] AC 79, 92 (Lord Atkinson).

3 *Clydebank Engineering & Shipbuilding Co Ltd v Don Jose Ramos Yzquierdo y Castaneda* [1905] AC 6, 11 (Earl of Halsbury LC), 20 (Lord Robertson).

4 *Cavendish Square Holding BV v Makdessi* [2016] AC 1172; [2015] 3 WLR 1373; [2015] UKSC 67, [23] (Lord Neuberger and Lord Sumption (Lord Carnwath agreeing)); *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd* [1915] AC 79, 90–91 (Lord Atkinson).

5 *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 90 ALJR 835; [2016] HCA 28, [59] (Kiefel J).

6 *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd* [1915] AC 79, 86–87 (Lord Dunedin).

7 *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 90 ALJR 835; [2016] HCA 28, [53] (Kiefel J), referring to *Clydebank Engineering & Shipbuilding Co Ltd v Don Jose Ramos Yzquierdo y Castaneda* [1905] AC 6, 10 (Earl of Halsbury LC).

[35.10.160] The "tests" to determine whether a contractual provision is a penalty are set

out in *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd* [1915] AC 79.[1] In that case, Lord Dunedin set out the principles regarding penalties. They can be summarised as:

(1) The term used to describe the payment is not definitive. While it is presumed the parties mean what they say when terms such as "penalty" or "liquidated damages" are used, the expression used is not conclusive.

(2) The essence of a penalty is that is it a payment which seeks to terrify the party who breaches the contract. The essence of liquidated damages is a genuine pre-estimate of damage that a party will suffer due to the breach.

(3) The question of whether a particular sum stipulated in a contact is a penalty is a question of construction, and to be determined upon the terms and circumstances of the contract. The term is to be judged at the time the contract was made, not at the time of breach.

(4) Various tests were created to assist in determining whether a stipulation is a penalty. These tests include:

    (a) The term will be a penalty if the sum demanded is extravagant or unconscionable in comparison to the greatest loss that could feasibly be proven to have resulted from the breach.

    (b) If the breach consists only of the payment of a sum of money, and the term seeks a larger sum than that which ought to have been paid, the term will be a penalty.

    (c) There will be a presumption (but no more) that a term is a penalty when it stipulates that a single lump sum should be paid as compensation should one or more of several events occur, where some of those events may result in serious and others result in minor damage to the innocent party.

    (d) However: in circumstances where it is almost impossible to make a precise pre-estimate of the damages resulting from a breach, it is more likely that the parties' intention was that a single lump sum be a genuine pre-estimate of damages, and therefore not a penalty.

The above summary of Lord Dunedin was meant only as a guide, and is not meant to be applied as if they were provisions of a statute. Later Australian case law has indicated that the critical issue in determining whether a term is a penalty is "whether the sum agreed was commensurate with the interest protected by the bargain".[2] Contemporary English case law has determined the distinction should be

> whether the sum or remedy stipulated as a consequence of a breach of contract is exorbitant or unconscionable when regard is had to the innocent party's interest in the performance of the contract.[3]

The party asserting that a particular provision is a penalty bears the onus of proving such.[4]

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1 *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd* [1915] AC 79, 86–87 (Lord Dunedin); *Arab Bank Australia Ltd v Sayde Developments Pty Ltd* [2016] NSWCA 328, [72] (McDougall J); *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656; 80 ALJR 219; [2005] HCA 71, [11] (the Court).

2 *Andrews v Australia & New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002; 6

BFRA 211; [2012] HCA 30, [75] (the Court); *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 90 ALJR 835; [2016] HCA 28, [270] (Keane J); *Cedar Meats (Aust) Pty Ltd v Five Star Lamb Pty Ltd* (2014) 45 VR 79; [2014] VSCA 32, [52] (the Court).

3 *Cavendish Square Holding BV v Makdessi* [2016] AC 1172; [2015] 3 WLR 1373; [2015] UKSC 67, [255] (Lord Hodge), cited in *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 90 ALJR 835; [2016] HCA 28, [270] (Keane J).

4 *Arab Bank Australia Ltd v Sayde Developments Pty Ltd* [2016] NSWCA 328, [75] (McDougall J), citing *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 90 ALJR 835; [2016] HCA 28, [167] (Gageler J).

[35.10.170] Certain damage to the innocent party can be classified as a "pre-estimate of damages" when determining whether a provision is a penalty. In circumstances where the damage inflicted upon the innocent party by a breach cannot be determined, the question of whether the amount stipulated by a term is "unconscionable or extravagant" must be determined by an investigation into the identified interests of the innocent party.[1]

Before determining what may be considered the interests of the innocent party, it must be clarified that the amount to be paid as a result of the breach must not merely be disproportionate to the loss of the innocent party to be considered a penalty, but must be "out of all proportion"[2] to "any legitimate interest of the innocent party".[3]

The rule against penalties is expressed in such exceptional language due to the principle that judicial interference with parties' freedom of contract requires exceptional circumstances.[4]

A legitimate interest of the innocent party must be determined by an examination of the context of the contract. This will often require an understanding of the commercial realities in which the contract was made, and what interests exist therein.[5] In the case of *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 90 ALJR 835; [2016] HCA 28, the interests of a bank extending credit to consumer were found to include:

(1) Costs incurred as a result of the late payment of credit card balances.

(2) The bank's compensation for the risk inherent in making the credit facility available to a customer.[6]

(3) The freedom the bank obtains as a result of timely payment of credit card balances, to pursue other more profitable ventures.[7]

The High Court determined in *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656; 80 ALJR 219; [2005] HCA 71 that the law of penalties will arise where the sum required to be paid by the breaching party exceeds a genuine pre-estimate of the damage that would have been caused by the breach.[8] The use of the term "damage" rather than the term "damages" indicates that the court must look at the loss that was caused by the breach, rather than what could be awarded as damages by a court following litigation.[9] Hence, such a pre-estimate may encompass loss suffered by the innocent party that would be too remote to be compensable under the rules in *Hadley v Baxendale* (1854) 9 Ex 341; 156 ER 145.[10] Similarly, the loss suffered by the innocent party will not be limited by the question of causation, especially where the damage to the innocent party's interests are intangible and unquantifiable.[11]

1 *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 90 ALJR 835; [2016] HCA 28, [52] (Kiefel J), referring to *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd* [1915] AC 79, 92 (Lord Atkinson); *Clydebank Engineering & Shipbuilding Co Ltd v Don Jose Ramos Yzquierdo y Castaneda* [1905] AC 6, 20 (Lord Robertson). See also "Unfair Contract Terms" [35.9.1615].

2 *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656; 80 ALJR 219; [2005] HCA 71, [31]–[32] (the Court), citing *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170; 60 ALJR 741, 190 (Mason and Wilson JJ) (CLR); *PSAL Ltd v Kellas-Sharpe* (2012) 7 BFRA 337; [2012] QSC 31, [60] (Applegarth J); *Bay Bon Investments v Selvarajah* [2008] NSWSC 1251, [49] (White J).

3 *Cavendish Square Holding BV v Makdessi* [2016] AC 1172; [2015] 3 WLR 1373; [2015] UKSC 67, [32] (Lord Neuberger and Lord Sumption (Lord Carnwath agreeing)), referred to in *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 90 ALJR 835; [2016] HCA 28, [22] (Kiefel J).

4 *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656; 80 ALJR 219; [2005] HCA 71, [31]–[32] (the Court); *PSAL Ltd v Kellas-Sharpe* (2012) 7 BFRA 337; [2012] QSC 31, [60] (Applegarth J); *Bay Bon Investments v Selvarajah* [2008] NSWSC 1251, [49] (White J).

5 *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 90 ALJR 835; [2016] HCA 28, [272]–[273] (Keane J), referring to the tests in *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd* [1915] AC 79, 87–88 (Lord Dunedin).

6 *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 90 ALJR 835; [2016] HCA 28, [275]–[277] (Keane J), referring to *Smiley v Citibank (South Dakota) NA* 517 US 735 (1996).

7 *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 90 ALJR 835; [2016] HCA 28, [278] (Keane J).

8 *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656; 80 ALJR 219; [2005] HCA 71, [10] (the Court).

9 *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 90 ALJR 835; [2016] HCA 28, [282]–[283] (Keane J), referring to *Mahony v J Kruschich (Demolitions) Pty Ltd* (1985) 156 CLR 522; 59 ALJR 504, 527 (the Court) (CLR).

10 *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 90 ALJR 835; [2016] HCA 28, [283] (Keane J). See also "Unconscionable Conduct and Consumer Protection Legislation" [35.9.830].

11 *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 90 ALJR 835; [2016] HCA 28, [161] (Gageler J), referring to *Clydebank Engineering & Shipbuilding Co Ltd v Don Jose Ramos Yzquierdo y Castaneda* [1905] AC 6; *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd* [1915] AC 79.

[35.10.180] There is debate over whether the modern rule against penalties exists as a rule of equity or a rule of law. The case of *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170; 60 ALJR 741 had formerly been interpreted as a basis for the principle in Australia that "[t]he modern rule against penalties is a rule of law, not equity".[1]

The case of *Andrews v Australia & New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002; 6 BFRA 211; [2012] HCA 30 rejected this interpretation of the modern rule against penalties. *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170; 60 ALJR 741 accepted the principle that a contractual provision that is found to be a penalty is unenforceable at common law without necessarily requiring the intervention of equity.[2] However, this does not indicate that the equitable doctrine against penalties has been removed entirely, but merely decreased in scope to include only those circumstances where the party seeking the term be rendered unenforceable is constrained to seeking relief that is only available in equity.[3]

1 *Interstar Wholesale Finance Pty Ltd v Integral Home Loans Pty Ltd* (2008) 257 ALR 292; [2008] NSWCA 310, [99] (Allsop P (Giles and Ipp JJA agreeing)).
2 *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 90 ALJR 835; [2016] HCA 28, [122] (Gageler J), referring to *Citicorp Australia Ltd v Hendry* (1985) 4 NSWLR 1, 39–40 (Priestley JA).
3 *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 90 ALJR 835; [2016] HCA 28, [123]–[124] (Gageler J). See also *Equity* "History and Nature of Equitable Jurisdiction" [15.1.150]–[15.1.310].

[35.10.190] Relief against forfeiture is an equitable remedy available to a party who has breached a term of a contract, and it would be unconscientious to allow the innocent party to rely on their legal rights under the contract or to terminate the contract.[1] Similarly to the rule against penalties, the court is reluctant to intervene in a contract made between fully informed parties.[2] However, "exceptional circumstances" must not necessarily exist before such judicial interference is available.[3]

Relief against forfeiture is primarily available in two contexts:

(1) when a vendor has validly terminated a contract for sale of land (see [35.10.210]); or

(2) where a lessor has terminated a lease, due to the non-payment of rent by the lessee, or due to any other breach by the lessee: see [35.10.220]–[35.10.250].

1 *Tanwar Enterprises Pty Ltd v Cauchi* (2003) 217 CLR 315; 77 ALJR 1853; [2003] HCA 57, [5], [19], [57]–[60] (Gleeson CJ, McHugh, Gummow, Hayne and Heydon JJ); *Romanos v Pentagold Investments Pty Limited* (2003) 217 CLR 367; 77 ALJR 1882; [2003] HCA 58, [21] (Gleeson CJ, McHugh, Gummow, Hayne and Heydon JJ); *RHG Mortgage Securities Pty Ltd v BNY Trust Company of Australia Ltd* [2009] NSWSC 1432, [137] (McDougall J). See also *Contract: General Principles* "Exercising Right to Terminate" [7.6.1540]–[7.6.1605]; "Relief against Forfeiture" [7.9.1250]–[7.9.1400].
2 *Tanwar Enterprises Pty Ltd v Cauchi* (2003) 217 CLR 315; 77 ALJR 1853; [2003] HCA 57, [59] (Gleeson CJ, McHugh, Gummow, Hayne and Heydon JJ), referring to *Stern v McArthur* (1988) 165 CLR 489; 62 ALJR 588, 526 (Deane and Dawson JJ) (CLR); *RHG Mortgage Securities Pty Ltd v BNY Trust Company of Australia Ltd* [2009] NSWSC 1432, [136]–[137] (McDougall J).
3 *Hoy Mobile Pty Ltd v Allphones Retail Pty Ltd (No 2)* [2008] ATPR 42-240; [2008] FCA 810, [416] (Rares J); *RHG Mortgage Securities Pty Ltd v BNY Trust Company of Australia Ltd* [2009] NSWSC 1432, [136] (McDougall J); *O'Shea v Athanasakis* (2009) 14 BPR 27,093; [2009] NSWSC 1150, [86] (Forster J).

[35.10.200] The court will not try to reshape a contract into a more reasonable or fair form when events subsequent to the contract being signed have rendered one side's situation more favourable.[1] This must be acknowledged when determining whether the court will act to prevent the vendor enforcing a contractual right to terminate a contract for the sale of land.

The primary reasons it would be inequitable to insist on the termination of a contract due to a breach of its terms have been found to be "fraud, mistake, accident [and] surprise".[2] To attract the interference of equity, it is insufficient that the contract's effect have been changed by "mere supervening events and changes in the relevant circumstances".[3]

In regard to the grounds of mistake and accident, it is not necessary that the actions of the vendor have created or contributed to the circumstances which require equity to intervene.[4] Furthermore, in relation to the relief against forfeiture in the case of accident, where the accident that occurred could have been foreseen by the parties and protected against, equity will not relieve the aggrieved party.[5]

When neither the ground of accident nor mistake is relied upon by the purchaser, circumstances must have eventuated that make it plainly necessary for equity to intervene to relieve against unconscionable, or unconscientious, conduct,[6] and the vendor must have somehow contributed to the creation of those circumstances.[7]

The majority in *Legione v Hateley* (1983) 152 CLR 406; 57 ALJR 292 stated that the resolution of the following subsidiary questions would determine whether equity should intervene:

> (1) Did the conduct of the vendor contribute to the purchaser's breach? (2) Was the purchaser's breach (a) trivial or slight, and (b) inadvertent and not wilful? (3) What damage or other adverse consequences did the vendor suffer by reason of the purchaser's breach? (4) What is the magnitude of the purchaser's loss and the vendor's gain if the forfeiture is to stand? (5) Is specific performance with or without compensation an adequate safeguard for the vendor?[8]

Furthermore, specifically in cases where the parties have stated in their agreement that time is of the essence, equity will be reluctant to intervene where the contract was breached due to one party failing to complete the contract in time. In such circumstances, "exceptional circumstances" must be shown.[9]

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1 *Stern v McArthur* (1988) 165 CLR 489; 62 ALJR 588, 502–503 (Mason CJ (dissenting)) (CLR), considered an accurate statement of the law by the majority in *Tanwar Enterprises Pty Ltd v Cauchi* (2003) 217 CLR 315; 77 ALJR 1853; [2003] HCA 57, [37] (Gleeson CJ, McHugh, Gummow, Hayne and Heydon JJ); *Macquarie International Health Clinic Pty Ltd v Sydney South West Area Health Service* (2010) 15 BPR 28,563; [2010] NSWCA 268. See also "Unconscionable Dealing" [35.9.10]ff.

2 *Legione v Hateley* (1983) 152 CLR 406; 57 ALJR 292, 447–448 (Mason and Deane JJ) (CLR); *Shiloh Spinners Ltd v Harding* [1973] AC 691; [1973] 2 WLR 28. See also *Contract: General Principles* "Mistake" [7.2.470]–[7.2.760].

3 *Tanwar Enterprises Pty Ltd v Cauchi* (2003) 217 CLR 315; 77 ALJR 1853; [2003] HCA 57, [39] (Gleeson CJ, McHugh, Gummow, Hayne and Heydon JJ); *Romanos v Pentagold Investments Pty Limited* (2003) 217 CLR 367; 77 ALJR 1882; [2003] HCA 58, [24] (Gleeson CJ, McHugh, Gummow, Hayne and Heydon JJ); *James v Hill* [2004] NSWCA 301.

4 *Tanwar Enterprises Pty Ltd v Cauchi* (2003) 217 CLR 315; 77 ALJR 1853; [2003] HCA 57, [39] (Gleeson CJ, McHugh, Gummow, Hayne and Heydon JJ); *RHG Mortgage Securities Pty Ltd v BNY Trust Company of Australia Ltd* [2009] NSWSC 1432, [138] (McDougall J); *Re Prismex Technologies Pty Ltd* [2013] NSWSC 292, [58] (Brereton J).

5 *Tanwar Enterprises Pty Ltd v Cauchi* (2003) 217 CLR 315; 77 ALJR 1853; [2003] HCA 57, [66] (Gleeson CJ, McHugh, Gummow, Hayne and Heydon JJ); *Re Prismex Technologies Pty Ltd* [2013] NSWSC 292, [58] (Brereton J).

6 *Legione v Hateley* (1983) 152 CLR 406; 57 ALJR 292, 409 (Mason and Deane JJ) (CLR), referred to

in *Tanwar Enterprises Pty Ltd v Cauchi* (2003) 217 CLR 315; 77 ALJR 1853; [2003] HCA 57, [59] (Gleeson CJ, McHugh, Gummow, Hayne and Heydon JJ); *MNWA Pty Ltd v Deputy Federal Commissioner of Taxation* (2016) 34 ACLC 16-041; [2016] FCAFC 154, [140] (Rares J); *Rushcutters Bay Developments Pty Ltd v Dragon Asset Investment Pty Ltd* [2016] NSWSC 1324, [48] (Darke J). See also *Equity* "History and Nature of Equitable Jurisdiction" [15.1.260].

7 *Stern v McArthur* (1988) 165 CLR 489; 62 ALJR 588, 502–503 (Mason J) (CLR).

8 *Legione v Hateley* (1983) 152 CLR 406; 57 ALJR 292, 449 (Mason and Deane JJ) (CLR), referred to in *Tanwar Enterprises Pty Ltd v Cauchi* (2003) 217 CLR 315; 77 ALJR 1853; [2003] HCA 57, [40] (Gleeson CJ, McHugh, Gummow, Hayne and Heydon JJ); *O'Shea v Athanasakis* (2009) 14 BPR 27,093; [2009] NSWSC 1150, [87] (Forster J); *Trombone Investments Pty Ltd v TBT (Victoria) Pty Ltd* [2015] VSC 517.

9 *Tanwar Enterprises Pty Ltd v Cauchi* (2003) 217 CLR 315; 77 ALJR 1853; [2003] HCA 57, [106] (Kirby J); *Craig Hargraves Investments Pty Ltd v Australian Business Insurance Advisors Pty Ltd* (2011) 111 SASR 506; [2011] SASCFC 159, [68]–[69] (Stanley J). See also *Real Property* "Conditions of Sale" [28.18.1850].

[35.10.210] In cases involving the sale of land, the majority in the case *Tanwar Enterprises Pty Ltd v Cauchi* (2003) 217 CLR 315; 77 ALJR 1853; [2003] HCA 57 drew attention to a number of misconceptions that may arise where the phrase "unconscionable conduct" is used. These include:

(1) The phrase "unconscionable conduct" encourages false notions that:

    (a) unconscionable conduct is a distinct cause of action, similar to a tort; and

    (b) an equitable defence is created against the assertion of any legal right, where the assertion of that right would be unconscionable in the circumstances.

(2) To say that the conduct is all that need be shown is to suggest that it is all that can be shown. Hence, the existence of such conduct will be necessary both to create the equitable interest, and to justify the intervention of the court at the time the non-breaching party seeks to rely on their rights.

(3) Reference to "unconscionable conduct" may create a misapprehension that the sufficient foundation for equitable intervention may result merely from an element of hardship or unfairness in the terms of the contract, or in the manner in which it is performed.[1]

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1 *Tanwar Enterprises Pty Ltd v Cauchi* (2003) 217 CLR 315; 77 ALJR 1853; [2003] HCA 57, [24]–[26] (Gleeson CJ, McHugh, Gummow, Hayne and Heydon JJ); *VPlus Holdings Pty Ltd v Bank of Western Australia Ltd* (2012) 91 ACSR 545; [2012] NSWSC 1327, [71] (Stevenson J); *Highfield Property Investments Pty Ltd V Commercial & Residential Developments (SA) Pty Ltd* [2012] SASC 165, [325] (Blue J).

[35.10.220] In circumstances where the landlord has exercised or is seeking to exercise a right of re-entry to the property as the result of the lessee's failure to pay rent, the lessee has a number of possible remedies. In New South Wales, South Australia, Tasmania and Victoria, the Supreme Court is legislatively empowered to grant relief against forfeiture on terms as it sees fit, and if it does so to maintain the lessee's original rights under the lease, as if the lease had never terminated.[1]

In the Northern Territory and Queensland, a similar rule exists. However there is no presumption that the lease will be treated as if it were never terminated.[2]

Western Australia has no specific legislation dealing with relief from forfeiture in leases where the breach is the non-payment of rent. Rather, the Supreme Court has a general equitable jurisdiction, which has been found to include the power to provide relief against forfeiture.[3]

The Supreme Court of the Australian Capital Territory similarly relies upon the inherent power of the Court to relieve against forfeiture in the case of non-payment of rent.[4] Both the Australian Capital Territory and Western Australia have legislative provisions allowing the Supreme Court to grant relief against forfeiture of leases where the breach is something other than non-payment of rent: see [35.10.230].

In all States, the Court has a wide discretion on whether or not to grant relief against forfeiture to a lessee who has failed to pay rent. The principles applied in such cases are set out in *Pioneer Quarries (Sydney) Pty Ltd v Permanent Trustee Co of New South Wales Ltd* (1970) 2 BPR 9562:

(1) The power of the landlord to re-enter the property is considered security for the rent to be paid by the lessee. If the landlord can be put back into the position they were before the non-payment of rent, the lessee is entitled to relief once they have paid the landlord's costs, including rent, interest and other expenses.

(2) Relief is, however, not granted as of right. The court retains its discretion but may only refuse relief in very special circumstances.

(3) Some matters that may be relevant to the exercise of the court's discretion include:

   (a) rights of third parties that may have arisen since re-entry occurred;

   (b) history of non-payment of rent;

   (c) existence of any breach of a covenant other than the covenant to pay rent; and

   (d) any other exceptional circumstances.[5]

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1 *Supreme Court Act 1970* (NSW) s 73; *Landlord and Tenant Act 1936* (SA) s 9; *Supreme Court Civil Procedure Act 1932* (Tas) s 11(14); *Supreme Court Act 1986* (Vic) s 85. See also *Real Property* "Termination of Tenancy" [28.7.2760]–[28.7.3000].

2 *Law of Property Act 2000* (NT) s 138(2)–(3); *Property Law Act 1974* (Qld) s 124(2).

3 *Supreme Court Act 1935* (WA) s 16(1)(d); *Fremantle & District Trades Hall Industrial Association of Workers v Victor Motor Co Pty Ltd* [1963] WAR 201.

4 *Supreme Court Act 1933* (ACT) s 27 (which enables any defendant to rely upon equitable relief in existence before the Act was passed). Relief against forfeiture is within the inherent jurisdiction of the Supreme Court: *Shiloh Spinners Ltd v Harding* [1973] AC 691; [1973] 2 WLR 28, 722 (Lord Wilberforce) (AC).

5 *Pioneer Quarries (Sydney) Pty Ltd v Permanent Trustee Co of New South Wales Ltd* (1970) 2 BPR 9562 (NSWSC), 9575 (Hope J). See also C Wood, E Finnane and N Newton, *Equity Practice and Precedents* (Lawbook Co., 2008) 148.

[35.10.230] There is legislation in every State giving the Supreme Court the power to grant relief against forfeiture in circumstances other than where the issue is the non-payment of rent.[1] This relief can be granted by the Court on any terms it sees fit, and can include an injunction to restrain the lessee from committing a similar breach in the future.

The statutes in every State specify that the Court must take into account the circumstances of the case brought before it before exercising its discretion.[2] When determining whether to grant such relief, the Court is not so predisposed to grant relief as it would be if the breach were only non-payment of rent.

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1 *Civil Law (Property) Act 2006* (ACT) s 426; *Conveyancing Act 1919* (NSW) s 129; *Law of Property Act 2000* (NT) s 138(2)–(3); *Property Law Act 1974* (Qld) s 124(2); *Landlord and Tenant Act 1936* (SA) s 11; *Conveyancing and Law of Property Act 1884* (Tas) s 15; *Property Law Act 1958* (Vic) s 146(2)–(3); *Property Law Act 1969* (WA) s 81, particularly s 81(9).

2 *Shiloh Spinners Ltd v Harding* [1973] AC 691; [1973] 2 WLR 28, 725 (Lord Wilberforce) (AC); *Wynsix Hotels (Oxford St) Pty Ltd v Toomey* (2004) 17 BPR 32,635; [2004] NSWSC 236, [25] (Young CJ in Eq); *Hyman v Rose* [1912] AC 623, 631 (Earl Loreburn LC).

[35.10.240] Where a landlord pursues an action for re-entry against a lessee, in all States other than South Australia and Tasmania, the under-lessee may apply to the Court for the whole term of the lease or any lesser term to be vested in the under-lessee. The “property” in this case being the property comprised in the lease, or any part thereof. The Court can make such an order subject to any conditions that it sees fit.[1]

In South Australia and Tasmania, rather than specific provisions protecting under-lessees, the definitions of lessee are expanded to include under-lessees, allowing the Court to exercise the same discretion it would posses with regard to primary lessees.[2]

In all States, the provisions allow the under-lessee to bring their application in either the principal proceedings of the landlord against the lessee, or in separate proceedings initiated by the under-lessee.

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1 *Civil Law (Property) Act 2006* (ACT) s 428; *Conveyancing Act 1919* (NSW) s 130; *Law of Property Act 2000* (NT) s 139; *Property Law Act 1974* (Qld) s 125; *Property Law Act 1958* (Vic) s 146(4)–(5). See also *Real Property* “Subleases” [28.7.2060].

2 *Landlord and Tenant Act 1936* (SA) s 12; *Conveyancing and Law of Property Act 1884* (Tas) s 15(3).

[35.10.250] Relief against forfeiture in retail leases differs between jurisdictions. In New South Wales, Queensland, Victoria and Western Australia, the respective State tribunals have the power to make orders granting relief against forfeiture in retail lease disputes.[1]

In the Northern Territory, the Supreme Court retains its jurisdiction to grant relief against forfeiture in retail lease disputes, as such a dispute is excluded from that State’s retail tenancy dispute resolution procedure.[2]

In the Australian Capital Territory, South Australia and Tasmania, the States' Magistrate's Courts have the power to grant relief against forfeiture for retail leases.[3]

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1 *Retail Leases Act 1994* (NSW) s 72(1)(d); *Retail Shop Leases Act 1994* (Qld) s 103 (as long as the amount in dispute is less than $750,000, the Queensland Civil and Administrative Tribunal may make orders under *Retail Shop Leases Act 1994* (Qld) s 83(2) which are wide enough to encompass relief from forfeiture); *Retail Leases Act 2003* (Vic) s 89(2); *Commercial Tenancy (Retail Shops) Agreements Act 1985* (WA) s 26(4). See also *Real Property* "Retail Tenancies" [28.8.10]ff.

2 *Business Tenancies (Fair Dealings) Act 2003* (NT) s 83(2)(a).

3 *Leases (Commercial and Retail) Act 2001* (ACT) s 17 Table 17, s 144; *Retail and Commercial Leases Act 1995* (SA) s 68(2)(f); *Fair Trading (Code of Practice for Retail Tenancies) Regulations 1998* (Tas) Sch 1 cl 39 (the Magistrates Court has jurisdiction under the *Magistrates Court (Civil Division) Act 1992* (Tas) s 9(e)).