HIGH COURT OF AUSTRALIA

GUMMOW, KIRBY, HAYNE, HEYDON AND KIEFEL JJ

COMMISSIONER OF TAXATION APPELLANT

AND

SHANE DAY RESPONDENT

Commissioner of Taxation v Day
[2008] HCA 53
12 November 2008
S315/2008

ORDER

Appeal dismissed with costs.

On appeal from the Federal Court of Australia

Representation

D H Bloom QC with K J Deards for the appellant (instructed by Australian Government Solicitor)

M L Brabazon with A H Rider for the respondent (instructed by Leitch Hasson Dent Solicitors)

CATCHWORDS

Commissioner of Taxation v Day

Income tax – Allowable deductions – Respondent taxpayer incurred legal expenses in defending charges under the *Public Service Act* 1922 (Cth) – *Income Tax Assessment Act* 1997 (Cth) ("ITAA"), s 8-1(1) allowed deductions from assessable income of losses or outgoings incurred "in gaining or producing … assessable income" – Whether legal expenses incurred "in gaining or producing" assessable income – Connection requisite – What is productive of income.

Public service – Disciplinary procedures – Standards of conduct required of an "officer" of the Australian Public Service ("the Service") – Role and duties of officer of the Service – Relevance of incidents of public office to whether legal expenses incurred in gaining or producing assessable income.

Income tax – Allowable deductions – ITAA, s 8-1(2) provided that losses or outgoings of "private or domestic nature" could not be deducted – Whether legal expenses incurred by respondent of private nature.

Words and phrases – "deductibility", "incurred in gaining or producing … assessable income", "in the course of", "legal expenses", "private or domestic nature".

Income Tax Assessment Act 1997 (Cth), s 8-1.
Public Service Act 1922 (Cth), Pt III, Div 6.

1 GUMMOW, HAYNE, HEYDON AND KIEFEL JJ. The respondent was a senior compliance officer with the Australian Customs Service between 1997 and 1999. The *Public Service Act* 1922 (Cth), in force at the relevant time[1], provided that an officer may be charged with failure to fulfil his duty as an officer[2]. In that event an inquiry was to be held[3], and the officer charged could be suspended from duty pending the hearing and determination of the charge[4]. The officer holding the inquiry, if satisfied that the charge was made out, could direct that action be taken in relation to the officer the subject of the charge. Such action included deduction of salary, demotion or dismissal from the Australian Public Service[5] ("the Service").

2 The respondent was charged with failure of duty in 1998 ("the first charge") and in 1999 ("the third charges"). A second set of charges notified to the respondent is not relevant to this appeal. The respondent sought and obtained legal advice and representation in connection with the first and third charges (together, "the charges"). In his objection to the Commissioner of Taxation's notice of assessment of his income to taxation, for the year ended 30 June 2002, the respondent claimed that $37,077 should have been allowed as a deduction from his assessable income. That figure represents the balance of the legal expenses incurred by the respondent with respect to the charges, after recovery of costs under an order of the Federal Court with respect to the first charge. On 19 April 2005 the Commissioner disallowed that objection. The respondent appealed to the Federal Court under s 14ZZ(a)(ii) of the *Taxation Administration Act* 1953 (Cth).

3 Section 8-1(1) of the *Income Tax Assessment Act* 1997 (Cth) ("the ITAA") provides:

> "(1) You can ***deduct*** from your assessable income any loss or outgoing to the extent that:

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1 Repealed by Sched 1 to the *Public Employment (Consequential and Transitional) Amendment Act* 1999 (Cth).

2 *Public Service Act* 1922, s 61(2).

3 *Public Service Act* 1922, s 62(1).

4 *Public Service Act* 1922, s 63B(1)(d).

5 *Public Service Act* 1922, s 62(6).

(a) it is incurred in gaining or producing your assessable income; or

(b) it is necessarily incurred in carrying on a business for the purpose of gaining or producing your assessable income.

(2) However, you cannot deduct a loss or outgoing under this section to the extent that:

(a) it is a loss or outgoing of capital, or of a capital nature; or

(b) it is a loss or outgoing of a private or domestic nature."

4 The primary judge held that the legal expenses incurred with respect to the charges were not deductible within the meaning of sub-s (1)(a), but also held the Commissioner to be estopped from contending that to be the case so far as concerned the expenses relating to the third charges[6]. The Full Court of the Federal Court, by a majority (Spender and Edmonds JJ, Dowsett J dissenting), allowed the Commissioner's appeal on the issue of estoppel but allowed the respondent's cross-appeal, holding the expenses to have been properly deductible under s 8-1(1)(a), and remitted the matter to the Commissioner for determination according to law[7].

5 The focus of this appeal is upon the requirement for deductibility of expenses in s 8-1(1)(a), that they be "incurred in gaining or producing … assessable income". It is the Commissioner's principal contention that the legal expenses were incurred in defending charges of conduct extraneous to the performance of the respondent's income-producing activities and therefore cannot be said to have been incurred in the course of gaining or producing assessable income.

The charges

6 Section 56 of the *Public Service Act* 1922 provided that an officer shall be taken to have failed to fulfil his duty as an officer if and only if:

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6 *Day v Federal Commissioner of Taxation* (2006) 62 ATR 530 at 541-542 [52], 546 [72] per Emmett J.

7 *Federal Commissioner of Taxation v Day* (2007) 164 FCR 250.

"(a) he wilfully disobeys, or wilfully disregards, a direction given by a person having authority to give the direction, being a direction with which it is his duty as an officer to comply;

(b) he is inefficient or incompetent for reasons or causes within his own control;

(c) he is negligent or careless in the discharge of his duties;

(d) he engages in improper conduct as an officer;

(e) he engages in improper conduct otherwise than as an officer, being conduct that affects adversely the performance of his duties or brings the Service into disrepute;

(ea) the officer engages in conduct (including patronage, favouritism or discrimination) in breach of section 33;

(f) he contravenes or fails to comply with:

(i) a provision of this Act, of the regulations or of a determination in force under subsection 9(7A) or section 82D, being a provision that is applicable to him; or

(ii) the terms and conditions upon which he is employed; or

(g) he has, whether before or after becoming an officer, wilfully supplied to an officer or another person acting on behalf of the Commonwealth incorrect or misleading information in connexion with his appointment to the Service."

7 The first charge, notified to the respondent on 23 September 1998 by an authorised officer of the Customs Service, was of improper conduct (s 56(d)). The respondent was suspended from duty. The particulars of that charge were that the respondent had breached the standard of conduct for officers set out in the Customs Code of Ethics and Conduct "Official Identification and Security Items" in that he presented his Customs identification card to a Clerk of the Downing Centre Local Court in New South Wales in order to obtain information with respect to a search warrant which had been executed on the Customs Service on 28 July 1998. The warrant had authorised the Australian Federal Police to search the respondent's workstation and the respondent had attempted, unsuccessfully, to obtain a copy of the search warrant. The officer conducting the inquiry found that it was improper for the respondent to have conveyed that his purpose was official.

8 The inquiry officer directed that the respondent be demoted and his salary consequentially reduced. The respondent exercised his right of appeal to the Disciplinary Appeal Committee[8], which found the charge proved, but varied the direction so that the respondent was to be transferred to a position and salary higher than the inquiry officer had directed. In proceedings for judicial review of that decision, brought in the Federal Court, Gyles J found that the Disciplinary Appeal Committee was able to conclude that the conduct of the respondent was conduct of an officer for the purposes of s 56(d) of the *Public Service Act* 1922, but that the conduct was not improper. His Honour set aside the decision and remitted it to the Committee for hearing according to law[9]. A Full Court dismissed the Commonwealth's appeal from his Honour's decision[10]. The Disciplinary Appeal Committee set aside the direction of the inquiry officer and ordered the Commonwealth to pay the respondent's costs. The respondent's other entitlements were restored as a consequence of the decision.

9 The seven charges making up the third set of charges were also referable to conduct described in s 56(d). On notification of these charges the respondent was suspended without salary. Three of the charges related to the respondent's conduct in connection with a claim for a diesel fuel rebate by the partner of another Customs officer. It was alleged that the respondent failed to inform Customs of relevant information, that he had lent the other officer improper support and assistance and that he was knowingly concerned in the creation of a false diary which supported the claim. The fourth charge was that he had secured access to, and acquired the use of, a work vehicle. The use included the collection and transportation of his daughter, by a fellow officer, for a non-work-related purpose. Two further charges involved his actions to conceal his absences from work. On one occasion he had asked a colleague to provide an excuse to his supervisor, to abstain from recording his absence and to switch his computer on. On another he submitted an attendance record which was false. The seventh charge involved a failure to communicate certain information concerning an investigation into an individual.

10 The charges were notified to the respondent on 22 March 1999. The respondent commenced proceedings in the Federal Court on 24 August 1999, in

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8 *Public Service Act* 1922, s 63D.

9 *Day v Douglas* [1999] FCA 1444.

10 *Commonwealth v Day* [2000] FCA 474 (Drummond, Whitlam and North JJ).

which it was alleged that information contained in telephonic communications, which had been intercepted by the Australian Federal Police as part of a criminal investigation, had been made available to officers of Customs including the officer who gave notice of the third charges, and that that communication was unlawful. He sought orders that the third charges be set aside and that the inquiry under s 62 of the *Public Service Act* 1922 be stayed, and a declaration. That application[11], an appeal to a Full Court[12], and an application for special leave to appeal to this Court were refused with costs.

The decisions of the Federal Court

11 Emmett J's holding, that the Commissioner was estopped from asserting that the legal expenses incurred by the respondent with respect to the third charges were not deductible, was based upon an order made by the Federal Court in earlier proceedings, to which the Commissioner consented, which allowed a deduction for fees paid to one counsel for legal advice in connection with the third charges. His Honour took the view that the Court must be taken thereby to have determined the deductibility of the other legal expenses referable to those charges[13]. It is not necessary to consider that aspect of his Honour's reasoning further. The Full Court upheld the Commissioner's appeal in that regard, and the respondent does not seek to raise that aspect of the Court's decision. This appeal is concerned solely with the question of the deductibility of the legal expenses by reference to s 8-1(1).

12 The judges in the Federal Court were divided in their opinions on the issue of deductibility. Dowsett J, in his dissenting judgment in the Full Court, agreed with the primary judge, Emmett J, that the legal expenses were not deductible because the conduct the subject of the charges comprised acts unconnected to the duties to be performed by the respondent in the course of earning assessable income[14]. The misuse of the respondent's identity card was unrelated to the performance of his duties and none of the conduct referred to in the third charges

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11 *Day v Commissioner of Australian Federal Police* (2000) 96 IR 240.

12 *Day v Commissioner, Australian Federal Police* (2000) 101 FCR 66.

13 *Day v Federal Commissioner of Taxation* (2006) 62 ATR 530 at 546 [71]-[72].

14 *Day v Federal Commissioner of Taxation* (2006) 62 ATR 530 at 540 [43], 541-542 [52] per Emmett J; *Federal Commissioner of Taxation v Day* (2007) 164 FCR 250 at 259 [52], 267 [73] per Dowsett J.

was performed by the respondent in the discharge of his duties as a customs officer[15].

13 The majority in the Full Court held that the expenditure was allowable as a deduction but differed in their reasoning to that conclusion. Spender J considered it to be irrelevant whether the conduct the subject of the charges was extraneous to the discharge of his duties[16]. Because the expression "incurred in gaining or producing … assessable income" is to be given a very wide application[17], it was necessary to consider the purpose of defending the charges, his Honour reasoned. The purpose of the respondent was to protect himself from the consequences of s 62(6) of the *Public Service Act* 1922, and therefore to protect his recurrent employment income from diminution or loss[18]. Expenditure in defence of a taxpayer's employment satisfies the test in s 8-1(1)(a)[19].

14 His Honour's reasoning[20] was to the contrary of Emmett J, who considered that the expenses were properly characterised by reference to the activity or conduct that made it necessary to incur the expenses, rather than the object sought to be achieved in the proceedings in which they were incurred. It was therefore not sufficient to say that the proceedings were taken in order to protect one's reputation or keep one's job. Dowsett J was of the same opinion. His Honour considered that it followed from the decision of this Court in *Federal Commissioner of Taxation v Payne*[21], that purpose alone would not suffice to permit allowance of an outgoing as a deduction.

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15 *Federal Commissioner of Taxation v Day* (2007) 164 FCR 250 at 268 [77], 269 [84].

16 *Federal Commissioner of Taxation v Day* (2007) 164 FCR 250 at 257 [34].

17 *Federal Commissioner of Taxation v Day* (2007) 164 FCR 250 at 256 [25], citing *Amalgamated Zinc (De Bavay's) Ltd v Federal Commissioner of Taxation* (1935) 54 CLR 295 at 303 per Latham CJ; [1935] HCA 81.

18 *Federal Commissioner of Taxation v Day* (2007) 164 FCR 250 at 256 [27]-[28].

19 *Federal Commissioner of Taxation v Day* (2007) 164 FCR 250 at 257 [31].

20 *Federal Commissioner of Taxation v Day* (2007) 164 FCR 250 at 257 [35].

21 (2001) 202 CLR 93; [2001] HCA 3.

15 The other member of the majority in the Full Court, Edmonds J, referred to the following passage from the majority judgment in *Payne*[22]:

> "The connection which must be demonstrated between an outgoing and the assessable income, in order to fall within the first limb of s 51(1), is that the outgoing is 'incurred in gaining or producing' that income. The subsection does not speak of outgoings incurred 'in connection with' the derivation of assessable income or outgoings incurred 'for the purpose of' deriving assessable income. It has long been established that 'incurred in gaining or producing' is to be understood as meaning incurred 'in the course of' gaining or producing[23]. What is meant by being incurred 'in the course of' gaining or producing income was amplified in *Ronpibon Tin NL and Tongkah Compound NL v Federal Commissioner of Taxation*[24] where it was said that[25]:
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> > 'to come within the initial part of [s 51(1)] it is both sufficient and necessary that the occasion of the loss or outgoing should be found in whatever is productive of the assessable income or, if none be produced, would be expected to produce assessable income.'"

16 In his Honour's view, the test in *Ronpibon Tin* was helpful in the present case. On that test it was the employment of the taxpayer which was the occasion of the incurrence of the expenditure[26]. The respondent's performance and observance of the duties of the employment were productive of assessable

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22 (2001) 202 CLR 93 at 99 [9] per Gleeson CJ, Kirby and Hayne JJ.

23 *Amalgamated Zinc (De Bavay's) Ltd v Federal Commissioner of Taxation* (1935) 54 CLR 295 at 303 per Latham CJ, 309 per Dixon J; *Ronpibon Tin NL and Tongkah Compound NL v Federal Commissioner of Taxation* (1949) 78 CLR 47 at 56-57; [1949] HCA 15; *Charles Moore & Co (WA) Pty Ltd v Federal Commissioner of Taxation* (1956) 95 CLR 344 at 350; [1956] HCA 77.

24 (1949) 78 CLR 47. See also, eg, *John v Federal Commissioner of Taxation* (1989) 166 CLR 417 at 426; [1989] HCA 5; *Fletcher v Federal Commissioner of Taxation* (1991) 173 CLR 1 at 17; [1991] HCA 42; *Steele v Deputy Commissioner of Taxation* (1999) 197 CLR 459 at 467 [22]; [1999] HCA 7.

25 (1949) 78 CLR 47 at 57.

26 *Federal Commissioner of Taxation v Day* (2007) 164 FCR 250 at 271 [91], 273 [101].

income. Those duties extended to all those duties listed in s 56 of the *Public Service Act* 1922, non-compliance with which could lead to a charge of misconduct under s 61[27]. With respect to the charges, the respondent incurred legal expenses defending his performance and the observance of the duties of his employment. Expenditure incurred in defence of either is occasioned by the employment, his Honour concluded[28].

17 Special leave to appeal was granted in this matter on the Commissioner's undertaking to pay the costs of the respondent of the appeal and not to seek to disturb the orders for costs in the Federal Court.

The Commissioner's argument – s 8-1(1)(a) of the ITAA

18 On the Commissioner's argument, the task to be undertaken under s 8-1(1)(a) is to identify the activity that is productive of assessable income and then to determine whether the outgoing in question can properly be regarded as having been incurred "in the course of" that activity. The argument draws upon references in the majority judgment in *Payne* to the words "in the course of" as relevant in establishing the requisite connection between expenditure and the activity which is productive of income.

19 The Commissioner submits that expenses of a legal nature have been held deductible where they were necessitated by an activity which was part of, or incidental to, the business of the taxpayer[29]. An employee's legal expenses, in connection with charges of misconduct, have been held deductible because they reflected the day-to-day aspects of the employment or because the employee could be said to be defending the manner of performance of his duties of employment[30]. The expenses here in question were incurred in defending conduct outside the performance of the respondent's duties, and cannot be said to

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27 *Federal Commissioner of Taxation v Day* (2007) 164 FCR 250 at 273 [102].

28 *Federal Commissioner of Taxation v Day* (2007) 164 FCR 250 at 274 [104].

29 Referring to *Herald & Weekly Times Ltd v Federal Commissioner of Taxation* (1932) 48 CLR 113; [1932] HCA 56; *Federal Commissioner of Taxation v Snowden & Willson Pty Ltd* (1958) 99 CLR 431; [1958] HCA 23; *Putnin v Commissioner of Taxation* (1991) 27 FCR 508; *Magna Alloys and Research Pty Ltd v Federal Commissioner of Taxation* (1980) 33 ALR 213.

30 Referring to *Commissioner of Taxation v Rowe* (1995) 60 FCR 99 at 109 per Beaumont J, 113 per Burchett J.

have been incurred "in" or "in the course of" gaining or producing assessable income for the purposes of s 8-1(1)(a).

20 The Commissioner accepts that the respondent was also under an obligation, imposed by s 56(d) of the *Public Service Act* 1922, not to engage in improper conduct, but submits that the observance of that duty was not itself an activity which was productive of the respondent's income and was therefore not relevant. The Commissioner submits that a positive obligation to perform tasks of employment is different from one not to engage in certain other conduct, particularly where the conduct proscribed involves private misbehaviour. The Commissioner argues that the dichotomy between conduct undertaken in performance of the tasks for which the respondent was employed and improper conduct in breach of s 56(d) of the *Public Service Act* 1922, which was rejected by Edmonds J, is a distinction that s 8-1(1)(a) makes necessary. In the Commissioner's submission, the questions arising under the provision cannot be answered by identifying the occasion of the outgoing as the respondent's employment which, in a general sense, was productive of the respondent's income. The Commissioner says that the attention of s 8-1(1) is directed to specific activities which can be said to be productive of assessable income.

Consideration of the Commissioner's argument

21 The terms of s 8-1(1)(a) of the ITAA and its predecessors[31] have not been regarded as materially different[32]. They refer to a relationship between expenditure incurred and what is productive of assessable income, which is to say the connection necessary for deductibility[33]. The words "incurred in gaining or producing … assessable income", appearing in the section, have long been held to mean incurred "'*in the course of*' gaining or producing" income, as was observed in *Payne*[34]. In *Amalgamated Zinc (De Bavay's) Ltd v Federal*

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31 Section 51(1) of the *Income Tax Assessment Act* 1936 (Cth); s 23(1)(a) of the *Income Tax Assessment Act* 1922 (Cth).

32 *Federal Commissioner of Taxation v Citylink Melbourne Ltd* (2006) 228 CLR 1 at 30 [90] per Crennan J; [2006] HCA 35.

33 *Payne* (2001) 202 CLR 93 at 99-101 [9]-[13] per Gleeson CJ, Kirby and Hayne JJ, 112 [51] per Gaudron and Gummow JJ.

34 (2001) 202 CLR 93 at 99 [9] per Gleeson CJ, Kirby and Hayne JJ (emphasis added), referring to *Amalgamated Zinc (De Bavay's) Ltd v Federal Commissioner of Taxation* (1935) 54 CLR 295 at 303 per Latham CJ, 309 per Dixon J;

(Footnote continues on next page)

Commissioner of Taxation[35], Latham CJ explained that it was necessary to read "losses and outgoings … incurred in gaining or producing the assessable income" as incurred "in the course of" gaining or producing that income, in order to make the section[36] intelligible. Outgoings may have an effect in gaining income, but losses cannot, as they simply reduce income[37]. In *Commissioner of Taxation v Cooper*[38] Hill J observed that an outgoing might be referable to a year of income other than that in which it was incurred[39]. That was a reason why s 51(1) of the *Income Tax Assessment Act* 1936 (Cth) did not express the right to a deduction in terms of outgoings incurred to earn income[40]. The words "in the course of" therefore facilitate the application of s 8-1(1)(a). They do not require a direct connection between the expenditure in question and an activity itself productive of income.

22 Dixon J in *Amalgamated Zinc* said that the expression "incurred in gaining or producing the assessable income" should be given a very wide application[41], although in that case the taxpayer company's continuing liability to pay monies to a compensation fund for miners it had employed lost any connection to assessable income when its business ceased. In *Payne* the majority confirmed that the words require more than a causal connection between the expenditure and the derivation of income; something closer and more immediate. The expenditure must be incurred "in the course of" gaining or producing the assessable income[42]. Their Honours' reference to the words "in the course of"

Ronpibon Tin (1949) 78 CLR 47 at 56-57; *Charles Moore & Co (WA) Pty Ltd v Federal Commissioner of Taxation* (1956) 95 CLR 344 at 350.

35 (1935) 54 CLR 295.

36 Section 23(1)(a) of the *Income Tax Assessment Act* 1922 (Cth).

37 *Amalgamated Zinc (De Bavay's) Ltd v Federal Commissioner of Taxation* (1935) 54 CLR 295 at 303 per Latham CJ.

38 (1991) 29 FCR 177.

39 (1991) 29 FCR 177 at 197, referring to *Federal Commissioner of Taxation v Smith* (1981) 147 CLR 578; [1981] HCA 10.

40 *Commissioner of Taxation v Cooper* (1991) 29 FCR 177 at 197.

41 (1935) 54 CLR 295 at 309.

42 *Payne* (2001) 202 CLR 93 at 101 [13] per Gleeson CJ, Kirby and Hayne JJ.

should not be taken to suggest a closer or more direct connection between expenditure and that which is productive of assessable income than the words of the provision[43] themselves convey. Rather the words draw attention to the connection made necessary by the provision, which the majority considered on the facts of that case to be too remote.

23 *Payne* was concerned with expenses incurred by the taxpayer in travelling between his place of employment as a pilot and between the place where he conducted a deer farm. The majority held that the expenditure was not incurred in the course of either income-producing activity. Adapting the language of *Ronpibon Tin*, their Honours held that neither the taxpayer's employment nor the conduct of the business of a deer farm occasioned the outgoings for travel expenses. Rather they were occasioned by the need for the taxpayer to be in a position where he could set about the tasks from which income would be derived[44]. The expenditure was incurred in the interval between income-earning activities[45]. In *Cooper*, Hill J referred to an outgoing which preceded an income-earning operation or activity and which came at a point too soon to be an incident of, or relevant to, that activity. His Honour described the expenditure as referable to getting the work, rather than doing it[46].

24 The facts in *Payne* and *Cooper* are far removed from this case. It may also be observed that no issue arose in those cases concerning what tasks or duties are encompassed in what is productive of assessable income, as it does here. The references in those cases to the taxpayer's activities were to all that might be encompassed in an income-producing business or employment, not to discrete tasks. Those cases were concerned with the degree of connection to such a business or employment necessary for an expense to be deductible.

25 The Commissioner also sought support from cases which had dealt with the deductibility of legal expenses – being payments for legal services or of awards for damages – for both the closeness of the connection for which he contended and the identification of that which might be considered to be a necessary part of a business or employment.

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43 Section 51(1) of the *Income Tax Assessment Act* 1936 (Cth).

44 *Payne* (2001) 202 CLR 93 at 102 [14] per Gleeson CJ, Kirby and Hayne JJ.

45 *Payne* (2001) 202 CLR 93 at 102 [15] per Gleeson CJ, Kirby and Hayne JJ.

46 *Cooper* (1991) 29 FCR 177 at 198.

26 In *Herald & Weekly Times Ltd v Federal Commissioner of Taxation*[47] it was held that a newspaper publisher's liability for defamation had the necessary connection to the business, publication being the common source of both revenue and the liability which gave rise to the expenditure[48]. McTiernan J observed that only cessation of business would free the business from such expenditure[49]. Gavan Duffy CJ and Dixon J distinguished the case from others by reference to the degree of connection present between the business carried on and what gave rise to the liability for damages[50]. Their Honours referred to statements by Lord Loreburn LC in *Strong & Co v Woodifield*[51] that such losses can be deducted as are connected with the business, in the sense that they are really incidental to the trade itself. The illustration provided by his Lordship was the deductibility of losses sustained by a railway company in compensating passengers for accidents whilst travelling with the railway. On the other hand injury caused to a man walking in the street by a window shutter falling from a house associated with a grocer's shop would not be deductible as an expense of the grocery business. And, as his Lordship observed, there will be cases at the margin[52].

27 Expenses of advertising, to counter press reports, and legal costs before a Royal Commission incurred by a company the subject of allegations as to its business practices were held to be deductible in *Federal Commissioner of Taxation v Snowden & Willson Pty Ltd*[53]. Dixon CJ there identified the carrying on of the business as the source of the attacks and said that the taxpayer company "could do nothing else but defend itself, if it was to sustain its business"[54]. And

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47 (1932) 48 CLR 113.

48 (1932) 48 CLR 113 at 119 per Gavan Duffy CJ and Dixon J, 121 per Rich J.

49 *Herald & Weekly Times Ltd v Federal Commissioner of Taxation* (1932) 48 CLR 113 at 127.

50 *Herald & Weekly Times Ltd v Federal Commissioner of Taxation* (1932) 48 CLR 113 at 119.

51 [1906] AC 448 at 452.

52 *Strong & Co v Woodifield* [1906] AC 448 at 452.

53 (1958) 99 CLR 431.

54 *Federal Commissioner of Taxation v Snowden & Willson Pty Ltd* (1958) 99 CLR 431 at 437.

in *Magna Alloys and Research Pty Ltd v Federal Commissioner of Taxation*[55], a case concerned more with the relevance of a taxpayer's subjective purpose in relation to the expenditure, the legal expenses paid by the company for the defence of its directors from criminal charges, relating to the receipt of secret commissions, were held deductible because they were incurred in carrying on the business[56]. It may be thought that the directors' conduct there had qualities which might take it outside the scope of their proper tasks as directors. Nonetheless the connection with the taxpayer's business and the production of income is apparent.

28 Closer to the position of an employee are the decisions in *Commissioner of Taxation v Rowe*[57] and *Shokker v Commissioner of Taxation*[58]. In *Rowe* a shire engineer incurred legal expenses connected with an inquiry into complaints of his misconduct. A Full Court of the Federal Court held the expenses allowable as a deduction, but for reasons which differed in their identification of the connection with the taxpayer's employment. Beaumont J considered that it lay in the inquiry being concerned with the day-to-day aspects of his employment[59]; Burchett J because they were expended defending the manner in which he had performed his duties[60]; and Drummond J because they were incurred to preserve his existing contract of employment so that he could retain the recurrent benefit of his salary[61]. In *Shokker*[62] an employee of the Commissioner of Taxation had been charged with a criminal offence, in relation to his claim for sick leave in his employment. Drummond J considered that the factors that the charge was instigated by the employer, and that it could result in his dismissal, were matters

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55 (1980) 33 ALR 213.

56 *Magna Alloys and Research Pty Ltd v Federal Commissioner of Taxation* (1980) 33 ALR 213 at 225 per Brennan J, 238-239 per Deane and Fisher JJ.

57 (1995) 60 FCR 99.

58 (1999) 92 FCR 54.

59 *Rowe* (1995) 60 FCR 99 at 109.

60 *Rowe* (1995) 60 FCR 99 at 113, 114.

61 *Rowe* (1995) 60 FCR 99 at 116, 117.

62 (1999) 92 FCR 54.

to be taken into account in determining whether the necessary connection was present[63].

29 Expressions used in the cases, such as "incidental and relevant", as referable to a business, should not be thought to add more to the meaning of provisions such as s 8-1(1)(a) of the ITAA, or to narrow its operation. They should be taken to describe an attribute of an expenditure in a particular case, rather than being an exhaustive test for ascertaining the limits of the operation of the provision[64]. Reference in some cases to the expenditure having an "essential characteristic" must likewise be treated with some care. As Gaudron and Gummow JJ observed in *Payne*, the use of the term may avoid the evaluation which the section requires[65]. It is perhaps better understood as a statement of conclusion than of reasoning.

30 Section 8-1(1)(a) is couched in terms intended to cover any number of factual and legal situations in which expenditure is incurred by a taxpayer. Its language and breadth of application do not make possible a formula capable of application to the circumstances of each case[66]. Cases are helpful to show the connection found on the facts there present, but not always to explain how the search for the requisite connection is to be undertaken. *Payne* directs attention to the statement made in *Ronpibon Tin*, as to the question posed by a provision such as s 8-1(1)(a), as correct and appropriate to be applied. The question, as restated in *Payne*, is: "is the occasion of the outgoing found in whatever is productive of actual or expected income?"[67] That inquiry will provide a surer guide to ascertaining whether a loss or expenditure has been "incurred in [the course of] gaining or producing … assessable income".

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63 *Shokker* (1999) 92 FCR 54 at 62 [27].

64 *Lunney v Commissioner of Taxation* (1958) 100 CLR 478 at 497 per Williams, Kitto and Taylor JJ.

65 (2001) 202 CLR 93 at 110-111 [45]-[48], citing Professor Parsons, *Income Taxation in Australia: Principles of Income, Deductibility and Tax Accounting* (1985) at [8.62].

66 See *Lunney v Commissioner of Taxation* (1958) 100 CLR 478 at 495-496 per Williams, Kitto and Taylor JJ.

67 (2001) 202 CLR 93 at 100 [11].

31 Essential to the inquiry is the determination of what it is that is productive of assessable income. The dichotomy to which the Commissioner's argument refers, that between proper conduct and that which is proscribed, may pose some difficulty in the delineation of tasks which the Commissioner would describe as falling within or without the scope of a person's occupation. The present case furnishes an example. It is not clear where the Commissioner would place expenses incurred with respect to charges of inefficiency, incompetence or negligence under s 56 in the carrying out by an officer of ordinary day-to-day tasks.

32 It is not necessary to consider further the difficulties inherent in this aspect of the Commissioner's argument. The dichotomy may be relevant in other spheres of the law, but is not useful to determine the question arising under s 8-1(1)(a), as to what it is that is productive of a person's assessable income. It does little more than characterise conduct by reference to wrongdoing. In some cases a reference to conduct which is wrongful may be to that which is remote from a person's occupation. In others, such as the present case, it will be to that which is a breach of a duty imposed by the employment itself. A determination as to what is productive of assessable income in a particular case may need to take account of any number of positive and negative duties to be performed or observed by an employee or other salary-earner. It is that determination which provides the answer as to whether the occasion is provided for the expenditure in question.

33 That no narrow approach should be taken to the question of what is productive of a taxpayer's income is confirmed by cases which acknowledge that account should be taken of the whole of the operations of the business concerned in determining questions of deductibility[68]. A similar approach should be taken to what is productive of a salary-earner's income, whether it be described as employment or by reference to a bundle of tasks to be performed and duties to be observed. In some cases those duties to be observed may extend beyond what is contained in a contract of employment. In *Cooper*, Hill J, referring to the statement in *Ronpibon Tin*, observed that it will often be necessary to analyse with some care the operations or activities regularly carried on by the taxpayer[69],

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68 *Amalgamated Zinc* (1935) 54 CLR 295 at 309 per Dixon J; *W Nevill & Co Ltd v Federal Commissioner of Taxation* (1937) 56 CLR 290 at 307 per Dixon J; [1937] HCA 9; *Charles Moore & Co (WA) Pty Ltd v Federal Commissioner of Taxation* (1956) 95 CLR 344 at 349-350.

69 (1991) 29 FCR 177 at 198.

and Lockhart J referred to the need to have regard to the terms and conditions of a taxpayer's employment[70]. A reference to the "day-to-day" activities undertaken by a taxpayer may not be a sufficient description of what their position involves. So, in *Commissioner of Taxation v Finn*[71] expenses of a senior design architect in the public service incurred in travelling in order to improve the taxpayer's knowledge were considered in the context of his employment by the government in accordance with his conditions of service[72], and as referable to his prospects of promotion[73]. The essential difficulty with the Commissioner's argument in this case is that it does not fully recognise the scope of the respondent's role as an officer of the Public Service and what his office exposed him to.

The Public Service and the *Public Service Act* 1922

34 The incurring of legal expenses with respect to charges against an officer of the Service for failure of duty must be considered in the context of the special position which such an officer holds, the extent of the duty owed by the officer and the legislative provision for the enforcement and regulation of such duty. The public service legislation in Australia has served and serves public and constitutional purposes as well as those of employment, as Finn J observed in *McManus v Scott-Charlton*[74]. Such legislation facilitates government carrying into effect its constitutional obligations to act in the public interest[75]. For reasons of that interest and of government the legislation contains a number of strictures and limitations which go beyond the implied contractual duty that would be owed to an employer by many employees. In securing values proper to a public service, those of integrity and the maintenance of public confidence in that integrity, the legislation provides for the regulation and enforcement of the private conduct of public servants[76]. This extension, to what might be called

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70 (1991) 29 FCR 177 at 182.

71 (1961) 106 CLR 60; [1961] HCA 61.

72 (1961) 106 CLR 60 at 67 per Dixon CJ.

73 (1961) 106 CLR 60 at 65-66 per Dixon CJ.

74 (1996) 70 FCR 16 at 24.

75 *McManus v Scott-Charlton* (1996) 70 FCR 16 at 24, referring to *Attorney-General (UK) v Heinemann Publishers Australia Pty Ltd* (1987) 10 NSWLR 86 at 191.

76 *McManus v Scott-Charlton* (1996) 70 FCR 16 at 25.

private conduct, was evident in s 56(d) and (e) of the *Public Service Act* 1922, which provided that an officer may be taken to have "failed to fulfil his duty as an officer" if he engages in improper conduct as an officer or in improper conduct otherwise than as an officer, in the latter case the conduct "being conduct that affects adversely the performance of his duties or brings the Service into disrepute". It is noteworthy that in *McManus* Finn J rejected as untenable, as a generalisation, the submission that the only limiting directions that could be given to a public servant were those which have a nexus with the performance of that person's employment duties[77].

35 The chief object of the *Public Service Act* 1922 was "to constitute a public service for the efficient, equitable and proper conduct, in accordance with sound management practices, … of the public administration of the Australian Government"[78]. The provisions relating to disciplinary action were referable to the maintenance of those standards of conduct.

36 An "employee" was defined by the Act, but the definition of an "officer" did not include an employee[79], whose position and terms and conditions of employment were dealt with elsewhere in the Act[80]. Part III, Div 6 of the Act was concerned with the discipline of officers of the Service. It provided, in s 55, that "misconduct", in relation to an officer, meant a failure of the officer to fulfil his[81] duty as an officer. Subdivision C was referable to disciplinary action with respect to officers other than Secretaries of Departments. Section 61(2) of the Subdivision provided for the bringing of charges against such an officer by an officer authorised by the relevant Secretary[82]. Section 62(1)-(5) provided for the

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77 (1996) 70 FCR 16 at 25.

78 Section 6. Similar objects are stated in the current public service legislation. Whilst it does not refer to the bringing of charges, it provides for a Code of Conduct and a range of sanctions consequent upon its breach: see ss 13, 28 and 29 of the *Public Service Act* 1999 (Cth).

79 *Public Service Act* 1922, s 7.

80 Part III, Divs 10 and 10A.

81 The language of the Act.

82 The hearing of such charges does not involve the judicial power of the Commonwealth: see, eg, *Medical Board of Victoria v Meyer* (1937) 58 CLR 62 at 105 per Evatt J; [1937] HCA 47. See also *Comptroller-General of Customs v Disciplinary Appeal Committee* (1992) 35 FCR 466 at 474 per Gummow J;

(Footnote continues on next page)

holding of an inquiry into the charge, by an officer other than the officer who gave notice of the charge, and for the procedures to be undertaken and applied to statements before the inquiry officer. Where the inquiry officer was satisfied that there had been a failure, on the part of the officer, to fulfil his duty, sub-s (6) provided that he be counselled or that other action be taken. That action extended to admonition[83]; the deduction of a sum from salary[84]; reduction of salary[85]; transfer, with or without deduction of a sum from salary[86]; transfer to an office with reduction of salary for a period[87]; and transfer to a specified office at a lower classification[88]. The power exercised by the inquiry officer extended to dismissal[89]. In the period during which the hearing of the charge was undertaken, the officer charged might be subject to a directive that he be suspended from duties, if the relevant Secretary was of the opinion that it would be prejudicial to the effective operation of the Service, and to the interests of the public, if the officer was to continue to perform his duties[90]. An appeal to a Disciplinary Appeal Committee was provided by s 63D.

The occasion of the respondent's legal expenses

37 The respondent's position as an officer subject to the *Public Service Act* 1922 obliged him to observe standards of conduct extending beyond those in the performance of tasks associated with his office and exposed him to disciplinary

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R v White; Ex parte Byrnes (1963) 109 CLR 665 at 670-671 per Dixon CJ, Kitto, Taylor, Menzies and Windeyer JJ; [1963] HCA 58; *Kariapper v Wijesinha* [1968] AC 717 at 737-738 per Sir Douglas Menzies, delivering the judgment of the Board.

83 *Public Service Act* 1922, s 62(6)(a)(i).

84 *Public Service Act* 1922, s 62(6)(a)(ii).

85 *Public Service Act* 1922, s 62(6)(a)(iii).

86 *Public Service Act* 1922, s 62(6)(a)(iv) and (v).

87 *Public Service Act* 1922, s 62(6)(a)(vi).

88 *Public Service Act* 1922, s 62(6)(a)(vii).

89 *Public Service Act* 1922, s 62(6)(b).

90 *Public Service Act* 1922, s 63B.

procedures within the Service which might have consequences for the retention of his office or his salary. What was productive of his income must be understood in this light. It is neither realistic nor possible to excise from the scope of the respondent's service as an officer elements which may be associated with tasks and so identify them as income-producing. What was productive of his income by way of salary is to be found in all the incidents of his office in the Service to which the Act referred, including his obligation to observe standards of conduct, breach of which might entail disciplinary charges. The respondent's outgoings, by way of legal expenses, followed upon the bringing of the charges with respect to his conduct, or misconduct, as an officer. He was exposed to those charges and consequential expenses, by reason of his office. The charges cannot be considered as remote from his office, in the way that private conduct giving rise to criminal or other sanctions may be[91].

38 It was necessary for the respondent to obtain legal advice and representation in order to answer the charges and to preserve his position, in the same way that the company in *Snowden & Willson*[92] was obliged to act defensively. Whether the charges were well-founded, a fact which had not been established by the time the Full Court determined this matter, is not relevant to the question of deductibility[93]. The incurring of expenditure by an employee to defend a charge because it may result in his or her dismissal may not itself be sufficient in every case to establish the necessary connection to the employment or service which is productive of income. Much will depend upon what is entailed in the employment and the duties which it imposes upon an employee. In the present case the requisite connection is present.

Purpose

39 In many, if not most, cases the objective relationship between an expenditure and that which is productive of income will provide a sufficient answer to the inquiry posed by the section[94]. In many cases questions as to a taxpayer's motives, beyond what may be the outcome sought, may introduce an

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91 See *Herald & Weekly Times Ltd v Federal Commissioner of Taxation* (1932) 48 CLR 113 at 120.

92 (1958) 99 CLR 431.

93 See *Federal Commissioner of Taxation v Snowden & Willson Pty Ltd* (1958) 99 CLR 431 at 436.

94 *Fletcher v Federal Commissioner of Taxation* (1991) 173 CLR 1 at 18 per curiam.

unnecessary evidentiary complication into the statutory inquiry. In *Finn* Dixon CJ left open the question whether motive might be relevant[95]. In *Magna Alloys* Brennan J considered that the reference in some of the cases to a taxpayer's state of mind should not be taken as a statement of what the section required, but rather as an observation upon the evidence[96]. However *Fletcher v Federal Commissioner of Taxation* accepts that it may be relevant in the context of a voluntary expenditure[97]. In such a circumstance explanation may be seen as necessary. In most cases the reason for the expenditure will be apparent and it will not be necessary to inquire further. The question whether the expenditure has been incurred "in gaining or producing" income will look to the scope of the operations or activities and their relevance to expenditure, rather than to a taxpayer's reason for the expenditure[98]. In the present case it does not assume importance.

Conclusion

40 The respondent's duties as an officer of the Service, and the possible consequences to him of internal disciplinary proceedings and action with respect to the continuation or termination of his service, form part of what was productive of his assessable income in that capacity. Applying the inquiry as to connection posed by the section, as explained by *Ronpibon Tin*, the occasion of the legal expenses is to be found in his position as an officer. It follows that the expenses were properly allowable as deductions.

41 Much of the expense incurred with respect to the third charges was associated with the respondent's pre-emptive legal challenge to the evidentiary basis for those charges. It was not contended by the Commissioner that the expenses were remote from the charges so that they could not qualify for deductibility on that account.

42 Consideration of the respondent's position as an officer of the Service also provides the answer to the Commissioner's remaining contention, which relies upon the terms of s 8-1(2)(b) of the ITAA. The expenses cannot be viewed as of

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95 (1961) 106 CLR 60 at 67.

96 (1980) 33 ALR 213 at 217.

97 (1991) 173 CLR 1.

98 *Amalgamated Zinc* (1935) 54 CLR 295 at 309.

a private nature, in the way that some fines and penalties unconnected to a person's service may be.

Orders

43 The appeal should be dismissed and the Commissioner pay the respondent's costs, on the Commissioner's undertaking to do so.

44 KIRBY J. Mr Shane Day (the respondent) was an officer of Customs and of the Australian Public Service ("the Service"). He claimed that certain legal expenses incurred by him, in defending disciplinary charges brought against him pursuant to the provisions of the *Public Service Act* 1922 (Cth) ("the PSA")[99], were deductible from his taxable income for the relevant tax years.

45 The Commissioner's assessment of the taxable income allowed no such deduction. The respondent's objection to the assessment was disallowed. He then "appealed" to the Federal Court of Australia[100]. At first instance, the primary judge (Emmett J) found, in substance, that the expenses were not deductible[101]. On further appeal to the Full Court of the Federal Court, a majority[102] allowed the appeal and held that the expenses were deductible. Orders were made that the matter be returned to the Commissioner for re-determination according to law. By special leave, the Commissioner appeals to this Court.

46 A majority of this Court has concluded that the respondent's legal expenses were deductible and hence that the appeal should be dismissed. Consistently with what I take to be the meaning and purpose of the provisions of s 8-1 of the *Income Tax Assessment Act* 1997 (Cth) ("the ITAA"), and the authority of this Court in *Federal Commissioner of Taxation v Payne*[103], it is my opinion that the appeal should be allowed and the decision of the primary judge restored.

The meaning of the word "in"

47 The outcome of this appeal turns on the meaning and application of the preposition "in" appearing in s 8-1(1)(a) of the ITAA. It is not unusual for large

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99 The provisions have been repealed by Sched 1 to the *Public Employment (Consequential and Transitional) Amendment Act* 1999 (Cth).

100 *Taxation Administration Act* 1953 (Cth), s 14ZZ(a)(ii).

101 *Day v Federal Commissioner of Taxation* (2006) 62 ATR 530. There was a complication based on a conclusion of the primary judge that the Commissioner was estopped from alleging that charges incurred in the 2001 taxation year were deductible. That conclusion was unanimously reversed by the Full Federal Court. It is not in issue in this Court.

102 *Federal Commissioner of Taxation v Day* (2007) 164 FCR 250 (Spender and Edmonds JJ; Dowsett J dissenting).

103 (2001) 202 CLR 93; [2001] HCA 3.

questions of frequent legal application to depend upon such little words[104]. When such problems arise, where the Parliament has packed into a single word the operation of legislation in multiple circumstances, it is to be expected that courts will endeavour to elaborate and explain the operation of the word for the benefit of later decision-makers. Courts will proffer "principles" and synonyms in an endeavour to ensure that the legislation is applied consistently, so as to achieve its imputed parliamentary purposes[105]. In their particular applications of the word, and of such "principles" and synonyms, courts and other decision-makers will sometimes differ when considering new factual situations.

48 In the uncontested facts of this case, it cannot be said that the respondent incurred his legal expenses "in" (in the sense of "in the course of") gaining or producing his assessable income. The matters giving rise to his expenditure on legal expenses lacked the requisite temporal or other connection with gaining or producing his assessable income[106]. The conduct of the taxpayer that gave rise to the necessity of incurring legal expenses was "quite beyond anything contemplated as being involved in the taxpayer's duties"[107]. Alternatively, the expenditure was a loss or outgoing of a private nature. The Commissioner was therefore correct in deciding that the expenses were not deductible. The Full Court erred in concluding otherwise.

The facts and legislation

49 The background facts of this case are explained in the reasons of Gummow, Hayne, Heydon and Kiefel JJ ("the joint reasons")[108]. In considering those facts it is necessary to appreciate that, in some cases, conduct contrary to express or implied prohibitions in a contract of service or (as here) contrary to the provisions of s 56 of the PSA[109] (as then applying) will nonetheless be "closely

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104 For example, the preposition "by" in s 82 of the *Trade Practices Act* 1974 (Cth). See eg *Travel Compensation Fund v Tambree* (2005) 224 CLR 627 at 645 [53] of my reasons, 653 [79] per Callinan J; [2005] HCA 69.

105 cf *Federal Commissioner of Taxation v Payne* (2001) 202 CLR 93 at 105 [24].

106 cf *Amalgamated Zinc (De Bavay's) Ltd v Federal Commissioner of Taxation* (1935) 54 CLR 295 at 310 per Dixon J; [1935] HCA 81. The passage is cited by Dowsett J in *Day* (2007) 164 FCR 250 at 262 [58].

107 (2007) 164 FCR 250 at 269 [84] per Dowsett J.

108 Joint reasons at [2], [6]-[10].

109 PSA, s 56, set out in the joint reasons at [6].

connected to the performance of particular duties so that the infringing conduct may accurately be so described"[110].

50 This would most obviously be so where the alleged infringements of the officer, as charged, amounted to inefficiency or incompetence[111]; negligence or carelessness[112]; improper conduct that affects adversely the performance of duties or brings the Service into disrepute[113]; patronage, favouritism or discrimination[114]; failure to comply with provisions of the Act or terms and conditions of employment[115]; or the provision of incorrect or misleading information in connection with the appointment to the Service[116]. Even particular cases of wilful disobedience or wilfully disregarding directions given by a person in authority might conceivably, in some circumstances, amount to an inappropriate way of endeavouring to perform duties having a relevant connection with the duties of an officer in the Service.

51 In the present case, however, as Emmett J recorded at first instance, the respondent did not suggest that *any* of the conduct that led to the charges involved the performance by him of his duties and functions as a Customs officer[117]. This conclusion, unchallenged in the appeals (including before this Court), throws light on the statutory characterisation of the legal proceedings initiated by the respondent, in which he incurred the legal expenses for which he claims deduction.

52 In this as in other cases the facts are crucial. They require the application of the ITAA so as to fulfil its purposes. They demand that a conclusion which seems factually odd or unlikely (especially one that appears grounded in a construction that favours a special group of taxpayers, viz officers of the Service) should be carefully measured against the criteria expressed in the legislation, as explained in earlier decisions.

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110 (2007) 164 FCR 250 at 267 [73].

111 PSA, s 56(b).

112 PSA, s 56(c).

113 PSA, s 56(d) and (e).

114 PSA s 56(ea).

115 PSA, s 56(f).

116 PSA, s 56(g).

117 Noted (2007) 164 FCR 250 at 269 [82] per Dowsett J.

The charges

53 The 1998 charge ("the first charge"), brought pursuant to s 61(2) of the PSA, concerned a particularised breach of the Customs Code of Ethics and Conduct ("the Code") applicable to "official identification and security items". This charge related to an allegation that the respondent had presented his Customs identification card in order to gain access to an officer of the Local Court of New South Wales. The purpose of such use was to obtain information about a search warrant of interest to the respondent personally which had been executed on the Service in July 1998. It was uncontested that this conduct did not involve the performance of any of the respondent's duties or functions as a Customs officer. Self-evidently, to misuse a Customs identification card in such a way and for personal purposes (which did not, in the event, succeed) was seriously "improper conduct" on the part of the respondent.

54 Save for a possible approach that will shortly be mentioned[118], the undisputed circumstances that occasioned the subsequent legal representation of the respondent had nothing to do with the gaining or producing of his assessable income. The costs of the legal representation were thus incurred in defending the respondent from charges arising out of personal and extraneous conduct, not in the course of income-producing conduct of any kind.

55 So far as the 1999 charges ("the third charges") are concerned, the position was the same. Those charges were, in every particular, related to the defence of the respondent upon charges that in no way constituted a misguided, foolish or even stupid mode of performing his employment duties or functions as an officer of the Service.

56 In a similar way (subject to what follows), if the circumstances of the third charges are relevant to throw light on whether the resulting legal defence of the respondent was a loss or outgoing incurred by him in the course of gaining or producing his assessable income, the only conclusion on the uncontested facts was that the legal expenses exhibited an "entire lack of connection between the assessable income and the expenditure"[119]:

(1) Three of the seven charges in the third charges related to false claims allegedly lodged by the respondent for a diesel fuel rebate made by the partner of a Customs officer. It was contended that the respondent had lent improper support and assistance in relation to such claims; had failed

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118 These reasons, below at [70]-[74].

119 cf *Amalgamated Zinc* (1935) 54 CLR 295 at 310 per Dixon J.

to inform the Service of the false claims; and was knowingly concerned in creating a diary entry in connection with a later audit of the claims;

(2) The fourth charge in the third charges was that the respondent secured access to, and organised the use of, a work vehicle for a non-work-related purpose;

(3) The fifth charge was that the respondent signed and submitted a Customs Attendance Record which he knew to be false;

(4) The sixth charge was that the respondent took steps to mislead the Service into believing that he had attended work on a day on which he did not in fact attend work; and

(5) The seventh charge was that the respondent failed to inform his employer of matters relating to an investigation into a suspect, in circumstances where the respondent knew, or ought to have known, that the matters could be relevant to that investigation.

57 The third charges, so described, arose out of a criminal investigation undertaken by the Australian Federal Police (AFP) which involved the interception of telephonic communications with the respondent[120]. Transcripts of the intercepted communications had been provided by the AFP to the Service for use in connection with the investigation into the events leading to the charges. That step resulted in the charges against the respondent, giving rise to an inquiry under s 62 of the PSA. The legal proceedings in respect of which the professional fees were incurred were designed to secure a declaration that the provision of the transcripts to, and their use by, the Service were unlawful. Effectively, the respondent sought a decision excluding their use. He also claimed damages for the alleged unlawfulness[121].

58 Given the circumstances that gave rise to the charges occasioning the legal proceedings and representation, the fact that the respondent did not suggest that any of this conduct involved the performance by him of his duties as a Customs Officer is not surprising. On the face of things, the respondent was defending only his personal conduct and position. There was no arguable, or even conceivable, connection of any of the circumstances in the third charges to the respondent's performance of his income-producing activities for the Service.

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120 (2006) 62 ATR 530 at 535.

121 (2006) 62 ATR 530 at 536.

59 Whilst a defence along the lines undertaken was the respondent's right as a citizen and an accused, the consequential expenses were not incurred by the respondent *in the course of* the gaining or producing of his assessable income. The only real connection with the respondent's activities in the Service was so far as the legal representation might succeed in excluding the telephonic interception evidence, or otherwise defend the respondent's entitlement to continue receiving future income from the Service, and to avoid termination or other income-reducing consequences of his conduct.

The legislation

60 The relevant provisions of s 8-1 of the ITAA are set out in the joint reasons[122]. The critical words, presented by the alternative ways in which the Commissioner argued this appeal, state:

> "(1) You can ***deduct*** from your assessable income any loss or outgoing to the extent that
>
> (a) it is incurred in gaining or producing your assessable income; or
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> …
>
> (2) However, you cannot deduct a loss or outgoing under this section to the extent that:
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> …
>
> (b) it is a loss or outgoing of a private or domestic nature".

61 These paragraphs express both the "positive" and "negative" limbs of the deductibility provisions. Those features were present in the language of the predecessor provision, namely s 51(1) of the *Income Tax Assessment Act* 1936 (Cth) ("the 1936 Act"). It was common ground that there was no material difference between the succeeding provisions of the two statutes. The authorities on s 51(1) of the 1936 Act are available to help elucidate the meaning of s 8-1 of the ITAA.

62 The joint reasons describe the relevant provisions of the PSA and the Code[123]. There is no need for me to repeat any of these provisions.

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122 Joint reasons at [3].

123 Joint reasons at [6]-[7].

The decisional history

63 The joint reasons also explain the history of the litigation in which the respondent became embroiled, once he faced the successive charges of failure to fulfil his duties as an officer of the Service[124], including the decisions of the judges of the Federal Court, both at first instance and on appeal[125].

64 It is unnecessary for me to repeat that chronicle. Essentially, the majority in the Full Court of the Federal Court concluded that the legal expenses claimed by the respondent were of the requisite positive character to allow deductibility from the respondent's assessable income under s 8-1(1)(a) of the ITAA and lacked the negative characteristics mentioned in the disqualifying provisions of s 8-1(2)(b) of the ITAA. However, the judges in the majority in the Full Court of the Federal Court reached their respective conclusions by different lines of reasoning.

65 The presiding judge, Spender J, explained his reasons without referring to the most recent decision of this Court in *Payne's* case[126] on the ambit of deductibility. Edmonds J, on the other hand, referred to and extracted, passages from *Payne's* case at the forefront of his reasons[127]. Correctly, he accepted that it was necessary for the respondent, in order to establish deductibility, to bring his case within the reasoning of the majority in *Payne*. In the result, Edmonds J concluded this could, and should, be done. He said[128]:

> "[T]he test for deductibility of legal expenses is not whether the employee's conduct of activity that resulted in the need to take defensive proceedings was conduct or activity engaged in for the purpose of producing assessable income …; rather, as explained in *Payne*, it is whether the expenditure was incurred in the course of gaining or producing the assessable income, in the sense that the occasion of the expenditure is to be found in what is productive of assessable income.
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> … [I]t is the taxpayer's employment which is the occasion of the expenditure and the taxpayer's performance and observance of the duties of that employment is undoubtedly productive of assessable income.

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124 Joint reasons at [7]-[10].

125 Joint reasons at [11]-[17].

126 (2001) 202 CLR 93.

127 (2007) 164 FCR 250 at 270 [88]-[89].

128 (2007) 164 FCR 250 at 273-274 [101]-[102], [105] (citations omitted).

> … In the case of defensive expenditure such as the legal expenses incurred here, it is the 'occasion' of the incurrence of these expenses which is determinative, rather than the identification of the antecedent activities which gave rise to the proceedings and the bifurcation of those activities into duties of performance, expenditure on the defence of which is deductible, and duties of observance, expenditure on the defence of which is not deductible."

66 Although in his reasons at first instance Emmett J did not specifically refer to *Payne* his general approach was, in my view, consistent with the analysis of this Court in that case[129]. In the Full Court, Dowsett J, in his dissent, also placed *Payne* at the forefront of his reasons[130]. He affirmed the duty to apply *Payne* to the extent that it was, or might appear to be, different from earlier authority of this Court[131] or other and different authority in the Federal Court[132].

The issues

67 From the foregoing, it follows that two issues are presented to this Court. They concern whether the Full Court erred in upholding the respondent's claim to the deductibility of legal expenses he incurred in defending himself against the first and third charges:

(1) By concluding that such legal expenses were a loss or outgoing "incurred in gaining or producing [his] assessable income"; or

(2) By deciding that such loss or outgoing was not of a "private or domestic nature".

68 A cross-appeal, raising a different issue, originally propounded by the respondent was not ultimately pressed[133].

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129 It should be noted that Emmett J was not referred in argument to this Court's decision in *Payne*.

130 (2007) 164 FCR 250 at 266-267 [70]-[73].

131 (2007) 164 FCR 250 at 264 [62] referring to *W Nevill & Co Ltd v Federal Commissioner of Taxation* (1937) 56 CLR 290 at 304-305, 308; [1937] HCA 9.

132 See eg *W Nevill & Co Ltd v Federal Commissioner of Taxation* (1937) 56 CLR 290.

133 See also joint reasons at [11].

The common applicable principles

69 I agree with many of the principles referred to in the joint reasons. Thus, I agree that:

(1) The governing obligation of the decision-maker is to give effect to s 8-1 of the ITAA, specifically, by reference to sub-s (1)(a) and sub-s (2)(b). The foundation for the resolution of all questions presented by the law, when expressed in legislation, *is* the legislation. For the sake of consistency it is proper and natural that courts and administrators will examine earlier decisions involving the application of the legislation, in order to endeavour to arrive at compatible conclusions in analogous circumstances. However, the essential duty is to apply the law as enacted by the Parliament[134]. This requires scrutiny of the enacted words in their context and in the light of any relevant considerations of history or of legislative purpose[135];

(2) In the course of explaining the outcomes in succeeding factual circumstances, courts have sometimes offered synonyms, explanations and suggested tests or "principles" for applying the statute to the case in hand. Such endeavours, however well meaning, have to be approached with care[136]. The decision-maker is ultimately driven back to the application of the statutory test, rather than judicial or other reasoning;

(3) Given the very large variety of circumstances to which the abbreviated language of s 8-1 of the ITAA needs to be applied, it remains the case that "[a] very wide application should be given to the expression 'incurred in gaining or producing the assessable income'"[137];

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134 See eg *Central Bayside General Practice Association Ltd v Commissioner of State Revenue (Vic)* (2006) 228 CLR 168 at 198, fn 86 and cases there cited; [2006] HCA 43.

135 eg *CIC Insurance Ltd v Bankstown Football Club Ltd* (1997) 187 CLR 384 at 408; [1997] HCA 2; *Newcastle City Council v GIO General Ltd* (1997) 191 CLR 85 at 112-113; [1997] HCA 53; *Project Blue Sky Inc v Australian Broadcasting Corporation* (1998) 194 CLR 355 at 381 [69], 384 [78]; [1998] HCA 28.

136 As explained by Gaudron and Gummow JJ (dissenting) in *Payne* (2001) 202 CLR 93 at 110 [42], 111 [48] citing Parsons, *Income Taxation in Australia: Principles of Income, Deductibility and Tax Accounting* (1985) at [8.62]. See joint reasons at [29].

137 *Amalgamated Zinc* (1935) 54 CLR 295 at 309 per Dixon J. See joint reasons at [13].

(4) The result of an intersection of a myriad of often complex facts and an extremely brief statutory criterion is that whether the loss or outgoing is deductible will often be contestable. Informed decision-makers will sometimes reach contradictory opinions on the subject. Many decisions will arise at the margin[138]. Certainty of outcomes cannot be assured;

(5) For a very long time, this Court has adopted a view of the preposition "in", appearing in s 8-1 of the ITAA, as meaning "in the course of". Thus, in *Payne*, Gaudron and Gummow JJ pointed out that[139]:

> "Long before *Lodge* [*v Federal Commissioner of Taxation*[140]] the preposition 'in' was said in this Court here to have the force of 'in the course of' and to look to the relevance of the expenditure to the operations or activities in question rather than to purpose in itself."

The majority in *Payne*[141] drew attention to the fact that the statute[142]:

> "does not speak of outgoings incurred 'in connection with' the derivation of assessable income or outgoings incurred 'for the purpose of' deriving assessable income. It has long been established that 'incurred in gaining or producing' is to be understood as meaning incurred 'in the course of' gaining or producing[143]."

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138 *Strong & Co v Woodifield* [1906] AC 448 at 452 per Lord Loreburn LC ["Many cases might be put near the line, and no degree of ingenuity can frame a formula so precise and comprehensive as to solve at sight all the cases that may arise"].

139 (2001) 202 CLR 93 at 105 [25].

140 (1972) 128 CLR 171 at 175; [1972] HCA 49.

141 Gleeson CJ, Hayne J and myself at (2001) 202 CLR 93 at 99 [9].

142 Referring to s 51(1) of the 1936 Act having the same application as s 8-1(1) of the ITAA.

143 *Amalgamated Zinc* (1935) 54 CLR 295 at 303 per Latham CJ, 309 per Dixon J; *Ronpibon Tin NL and Tongkah Compound NL v Federal Commissioner of Taxation* (1949) 78 CLR 47 at 56-57; [1949] HCA 15; *Charles Moore & Co (WA) Pty Ltd v Federal Commissioner of Taxation* (1956) 95 CLR 344 at 350; [1956] HCA 77.

What is meant by incurred "in the course of" gaining or producing income was amplified in *Ronpibon Tin NL and Tongkah Compound NL v Federal Commissioner of Taxation*[144]:

> "[T]o come within the initial part of [s 51(1)] it is both sufficient and necessary that the *occasion* of the loss or outgoing should be found in whatever is productive of the assessable income or, if none be produced, would be expected to produce assessable income."

(6) Having regard to the purpose of s 8-1(1), and to the context (including s 8-1(2)(b)) essential to whether a loss or expenditure has been "incurred in [the course of] gaining or producing assessable income" is the determination of what it is that is productive of assessable income[145]. However, the interposition of the words "in the course of" in the legislation places emphasis upon a temporal and functional connection between the gaining or production of the assessable income and the incurring of the propounded deduction. It is not enough that the deduction claimed has some general, even *causative*, connection with the derivation of income. Nor is it enough that the outgoings were incurred for the *purpose* of deriving, or continuing to derive, the income. This has not been the *discrimen* accepted by this Court in decisions going back three-quarters of a century. Neither party in this appeal suggested that this Court should revisit the correctness of its decision in *Payne*. Given that equivalent language was adopted in the ITAA, substantively re-enacting the approach of s 51(1) of the 1936 Act, there are overwhelming reasons why this Court would not re-open the foregoing approach but should apply it; and

(7) So far as the provisions of s 8-1(2)(b) of the ITAA are concerned, it can be accepted that there will rarely be a case where an outgoing, incurred in gaining or producing assessable income, is also an outgoing of a purely "private" [or "domestic"] nature[146]. Whatever may be the case in other circumstances, in the present instance the issue to be decided is to be resolved by the application first of s 8-1(1)(a) of the ITAA and not by s 8-1(2)(b) of that Act. By the same token, the language of the latter

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144 (1949) 78 CLR 47 at 57 (emphasis added).

145 cf joint reasons at [30].

146 See *Federal Commissioner of Taxation v Hatchett* (1971) 125 CLR 494 at 498; [1971] HCA 47. See also *John v Federal Commissioner of Taxation* (1989) 166 CLR 417 at 431; [1989] HCA 5; cf Parsons, *Income Taxation in Australia: Principles of Income, Deductibility and Tax Accounting* (1985) at [8.2].

> provision, being part of the immediate textual context of the legislation to be applied, may be taken into account in giving meaning to an immediately preceding statutory provision. The minimum contextual consideration for deriving meaning, certainly in the English language, is the sentence and its surrounding provisions. It is not a contested word taken out of context[147]. The reference to "private" losses or outgoings (inferentially by contrast to notions such as "working expenses"[148]) may throw light on what the Parliament was intending by providing for deductions in s 8-1(1)(a). So may the indication in s 8-1(1)(b) providing for a deduction where "it is necessarily incurred in carrying on a business for the purpose of gaining or producing your assessable income". The emphasis is upon a relationship between the income and the loss or outgoing. But what precisely must that relationship be?

An alternative approach

70 *Justice Spender's approach*: In his reasons in the Full Court, Spender J adopted an approach significantly different from that adopted by any of the other judges.

71 In effect, Spender J concluded that the legal expenses incurred by the respondent were incurred in order to resist the potential consequences of the disciplinary charges against the respondent that might destroy, or adversely affect, his income source. It was on that footing that his Honour concluded that the respondent's legal costs were losses incurred *in* gaining or producing his assessable income. If there were no employment (or different or lesser employment following demotion, suspension or damage to career prospects) an obvious financial consequence would follow both for the respondent and for the revenue. Each was dependent on the continuing flow of the respondent's income derived from its source.

72 For a time, during argument, I found this approach attractive. I shall therefore explain Spender J's reasoning and indicate why, ultimately, I reject it.

73 *Justice Spender's reasoning*: In the course of his reasons, Spender J said[149]:

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147 *Collector of Customs v Agfa-Gevaert Ltd* (1996) 186 CLR 389 at 396-397; [1996] HCA 36 applying *R v Brown* [1996] 1 AC 543 at 561 per Lord Hoffmann.

148 See *Handley v Federal Commissioner of Taxation* (1981) 148 CLR 182; [1981] HCA 16; *Federal Commissioner of Taxation v Forsyth* (1981) 148 CLR 203; [1981] HCA 15; *Federal Commissioner of Taxation v Cooper* (1991) 29 FCR 177.

149 (2007) 164 FCR 250 at 256-257 [23]-[38]. The quotations have been compressed.

> "Where the case concerns the payment of legal expenses, the proper characterisation of the expenditure for tax purposes turns on a consideration of the circumstances with which the legal proceedings were concerned … In my judgment, the objective purpose of defending the … charges … was to protect the respondent from the consequences specified under s 62(6) of the [PSA], or to diminish their severity. The purpose was, therefore, to seek to protect the respondent's recurrent employment income from diminution or loss, or other adverse impact … In my opinion, expenses incurred in the defence of employment from that which threatens to destroy or diminish its income earning satisfies the positive test for deductibility. … The object in view in respect of the incurring of legal expenses in relation to the … charge[s] was to resist direct threats to the diminishing of, or the destruction of, the income-earning ability of the taxpayer. The situation which impelled the taxpayer to undertake the outlaying of those expenses was the fact that he had been charged under the [PSA] and the consequence of those charges being successful would be that his income would be diminished or lost. It is quite irrelevant whether the content of the charges related to activities of his employment, or were extraneous to the proper discharge of his duties. There would be no difference if a public servant was charged with being rude to customers in answering complaints, which is conduct engaged in by the public servant in the course of his or her duties, or a charge that he or she had downloaded child pornography from his or her office computer, conduct which is extraneous to the discharge of his or her duties as a public servant. The consequence of either charge being sustained is that the public servant's income might be diminished or lost. The legal expenses in defending either charge fall within the test set out by Dixon J in [*Hallstroms Pty Ltd v Federal Commissioner of Taxation*][150] … [and] by Drummond J in *Federal Commissioner of Taxation v Rowe*[151] … Drummond J said that [such] expenses had the requisite nexus because 'they were incurred to preserve his entitlement to receive in return for his services, assessable income'."

74 *Attractions of the theory*: Spender J's approach to the problem presented in this appeal has undoubted attractions:

- It offers a test for the recovery of legal expenses which is much simpler and more straightforward than that accepted by Edmonds J, the other judge in the majority in the Full Court of the Federal Court. Edmonds J's

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150 (1946) 72 CLR 634 at 645-652; [1946] HCA 34.

151 (1995) 60 FCR 99 at 115-116.

criterion for the deductibility of legal expenses was whether the taxpayer's employment was "the *occasion* of the expenditure and the taxpayer's performance and [whether] observance of the duties of that employment [was] … productive of assessable income"[152]. However, identifying the "occasion", as distinct from the motive and purpose, necessarily takes a court into a verbal analysis that is illusory or self-fulfilling. Spender J's approach avoids this;

- Spender J's approach also, upon one view, reflects a purposive analysis of the provision of s 8-1(1) of the ITAA. If the underlying object of that provision is to permit a taxpayer to offset losses and outgoings that have been incurred in the gaining or producing of assessable income, there can be no such more important loss or outgoing than that incurred in attempting to ensure that the flow of assessable income will continue, or remain at its previous level;

- Spender J's approach also arguably takes into account the particular perils of employment discipline faced by federal officials, including officers of the Service. Whilst all employment involves possible action resulting in dismissal, suspension, demotion and loss of benefits, employees who are officers of the Service face an additional and special danger in maintaining the source of their income. This included (at the applicable time) defending disciplinary proceedings under the PSA. To protect the income source in such proceedings might thus be seen as a particular incident of this particular type of employment ("office");

- The approach favoured by Spender J also avoids pre-judgment or collateral assessment of the antecedent conduct of the officer concerned, before allowing a deduction for any legal expenses. At the time of the claim for deduction, in many cases (as in that of the respondent himself), the full facts and evidence of the disciplinary proceedings will not be known when the claim for deduction is made. Similarly, at the time of the Commissioner's assessment, it must be decided *a priori*. It could not therefore depend upon a final resolution of the antecedent conduct or the charges based upon it. It is not part of the function of the ITAA, or taxation law generally, to add to the punishment of an office-holder embroiled in disciplinary proceedings;

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152 See *Day* (2007) 164 FCR 250 at 274 [105] (emphasis added). The reference to the "occasion" of the occurrence of these expenses appears to derive from the passage in this Court's reasons in *Ronpibon Tin NL* (1949) 78 CLR 47 at 57 cited above these reasons at [69].

- To the extent that there is uncertainty about the operation of s 8-1(1)(a), it is appropriate, in a society such as ours, to favour an interpretation of legislation that upholds the rule of law. This includes the practical entitlement of employees/officers to defend themselves against disciplinary charges, some of which may be contested on the facts. Some of those facts may also be disputed as to their seriousness or significance for continued employment, income and promotion. Even in disobedience and misconduct cases, the line between "purely private" wrongdoings and those that have some relevant nexus with the employment, will sometimes be difficult to draw. Spender J's approach concentrates on whether, in the circumstances, it can be concluded that the purpose (and hence the character) of the "loss or outgoing" expended on legal expenses, is to protect income source: a relatively simple and straightforward criterion to apply; and

- If the Parliament were dissatisfied with this approach to the meaning of s 8-1(1)(a), and concerned that it might over-extend the entitlement to deduct legal expenses for unmeritorious defences of purely private non-employment conduct giving rise to disciplinary charges against an employee or officer, it would be open to it to enact a more precise disqualifying provision. This, in effect, is what the Parliament did when, in 2005, it enacted s 26-54 of the ITAA. That amendment followed a decision of this Court refusing special leave to appeal from the judgment of the Full Court of the Federal Court in *Commissioner of Taxation v La Rosa*[153]. The Parliament enacted a special provision disallowing deductions for "a loss or outgoing to the extent that it was incurred in the furtherance of, or directly in relation to, a physical element of an offence against an Australian law of which you have been convicted if the offence was, or could have been, prosecuted on indictment". A special enactment could, if desired, be enacted to disallow deductions for legal expenses incurred in defending purely personal conduct having no relevant nexus to the employment and relating to purely personal activities of the taxpayer.

75 *Flaws in the alternative theory*: There is a fundamental difficulty in the alternative theory propounded by Spender J. Ultimately it is a difficulty that leads me to reject his Honour's analysis. The problem is exposed in the reasons of Dowsett J in the Full Court of the Federal Court. Essentially, it flows from the long-standing interpretation by this Court of s 8-1(1)(a) of the ITAA, and its predecessor provision. Specifically, it flows from the insistence, repeated most recently in *Payne*, that the word "in", as stated in s 8-1(1)(a), is to be read as

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153 (2003) 129 FCR 494.

equivalent to "in the course of". It is not to be read as "in connection with" or "for the purpose of" deriving the relevant assessable income[154].

76 *Payne* was a case concerned with a claim to deduct travelling expenses incurred by the taxpayer in travelling between two unrelated places of work, from each of which, separately, the taxpayer derived income. It was in that context that it became necessary for this Court to examine the theory of deductibility of expenses that are based upon the relevant *purpose* of the outgoings incurred or their *connection* with the derivation of assessable income. If such criteria had been adopted, the taxpayer in *Payne* would have had a very strong argument to be entitled to deduction. Clearly enough, the *purpose* of incurring the expenses in that case, of travelling from his residence on a rural farm to his place of employment as an airline pilot at the Sydney airport was to be able to earn both incomes. Moreover, the travel involved expenses incurred "*in connection with*" the latter employment and "*for the purpose of*" deriving assessable income from it.

77 The majority in *Payne* acknowledged the concerns that have been expressed over the years regarding the interpretation of deductibility under s 51(1) of the 1936 Act, specifically of travelling expenses incurred to get to and from a place of employment, particularly if the employment is remote from the taxpayer's ordinary residence. In *Lunney v Commissioner of Taxation*[155], Dixon CJ confessed to misgivings about the rule established by this Court for the interpretation of the provision of the Act in this respect. Dixon CJ even hinted that the rule might not be logically supportable and that "if the matter were to be worked out all over again"[156], a different approach might be taken. This notwithstanding, the Court in *Lunney* adhered to its insistence that "in", in the statutory provision, meant "in the course of" deriving the assessable income. It did not mean "for the purpose of" doing so or "in connection with" doing so.

78 In *Payne*, the majority of this Court reaffirmed that approach. They did so notwithstanding the problems and obscurities that it presented. Moreover, they did so knowing full well that the ruling had application far beyond travelling expenses, such as were in issue in that case[157]:

> "[T]he distinction has long been made and it is now too late for the Court to 'rip it up' and treat the section as allowing any and all deductions having

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154 *Payne* (2001) 202 CLR 93 at 99 [9].

155 (1958) 100 CLR 478; [1958] HCA 5.

156 (1958) 100 CLR 478 at 486.

157 *Payne* (2001) 202 CLR 93 at 102-103 [17].

> some causal connection with the derivation of assessable income. [The] cases … show [that] the distinction between outgoings incurred in the course of deriving income and other outgoings is a distinction which applies generally, not just in relation to travel expenses[158]. Once the distinction is recognised, it follows that the expenditure which was in issue in this case could not be held to be an allowable deduction."

79 Whilst the authority culminating in *Payne* stands, it is fatal to the basis upon which Spender J sought to justify the deductibility of the legal expenses incurred by the respondent. Even if it were conceded that such legal expenses were incurred "for the purpose of" ensuring the continuation of the derivation of the respondent's income or "in connection with" that purpose or the income that it produced, in the undisputed facts of the respondent's case it could not be said that the expense was incurred *in the course of* deriving the assessable income. The only way that that characteristic of the applicable loss or outgoing could be adopted would be to treat *all* such legal expenses as incurred *in the course of* deriving the relevant income. However, that approach would render the requirement of having to demonstrate the relationship between the loss or outgoing and the gaining or producing of the income meaningless.

80 All of this was well said by Dowsett J in the Full Court of the Federal Court[159]:

> "With all due respect, I am concerned that a test which focuses on whether costs were incurred to defend the taxpayer from loss of employment or diminution in income is a test based on purpose, and therefore inconsistent with the decision in *Payne* …
>
> I find it difficult to construe the language in the cases as necessarily establishing that conduct contrary to express prohibitions in a contract of service, and unconnected to the duties to be performed by the taxpayer, will be conduct *in the course of* earning assessable income. In some cases, the relevant prohibited conduct may be closely connected to the performance of particular duties so that the infringing conduct may accurately be so described. Negligence in such performance is a possible example. However, when the conduct is completely beyond the scope of the contract, and even forbidden by it, it does violence to language to describe that conduct as being *in the course of* earning assessable income."

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158 *Fletcher v Federal Commissioner of Taxation* (1991) 173 CLR 1 at 17; [1991] HCA 42.

159 (2007) 164 FCR 250 at 267 [72]-[73] (emphasis added).

81 *Conclusion: alternative theory rejected*: Freed from earlier authority, there might be arguable reasons of textual analysis, legal principle and policy to support the approach favoured by Spender J. However, his Honour's reasoning cannot be accepted consistently with the unchallenged approach expressed by the majority in *Payne*. This being so, one of the two judicial opinions relied on in the Federal Court to sustain the majority orders must be rejected.

82 But can the decision be supported on the reasoning of the other judge in the majority, Edmonds J, or upon any other view of the legislation, read consistently with *Payne*?

Conclusion: the legal expenses are not deductible

83 *The analysis of Justice Edmonds*: In his reasons, Edmonds J looked to whether the respondent's employment was the "occasion" of the expenditure on the legal expenses. If this protean word were intended to mean the reasons for the circumstance giving rise to the need to pay legal expenses, it would run into the same difficulties as were explained in *Payne*. If "occasion" is a synonym for "purpose", such that the respondent was entitled to defend the ongoing employment as the source of his income, it evidences the same error as that of Spender J.

84 The essential reasons that Edmonds J gave for his conclusion appears in the following passage of his reasons[160]:

> "[T]he taxpayer is incurring expenditure (legal expenses) defending … his performance of duties of his employment, and … his observance of duties of his employment. The performance of one kind of duty and the observance of the other kind of duty *equally contribute to the taxpayer's continued employment* which is productive of assessable income, and expenditure incurred in defence of either performance or observance of a duty is, in my view, occasioned by that employment. For that reason such expenditure is an allowable deduction."

85 As Dowsett J remarked, this reasoning in substance involves the adoption of a test based on *purpose*. It ignores the need for the taxpayer claiming the deduction, where it is contested, to demonstrate that the expenditure of the propounded deductions was incurred *in the course of* gaining or producing the assessable income.

86 *The nexus is rejected*: At least in the uncontested facts of this case, once this error is identified it is impossible to characterise the respondent's losses and

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160 (2007) 164 FCR 250 at 274 [104] (emphasis added).

outgoings as incurred *in the course of* gaining or producing the assessable income. The character of the respondent's legal proceedings is inescapably coloured by their subject matter which was to defend, or explain, the respondent's identified conduct which was never suggested to have involved the performance of his duties as a Customs officer. In that sense, within the authorities, the respondent's expenditure on legal representation cannot be classified as "incidental and relevant" to the winning or producing of the assessable income[161]. Instead, it must be classified (as Spender J had recognised) as a legal expense incurred so as to protect the respondent from dismissal, reduction in rank or reduction in pay. That is not sufficient to render the losses and outgoings incurred deductible. I agree with Dowsett J[162]:

> "Whilst such expenses are incurred for the purpose of deriving assessable income, they are not incurred in the course of doing so.
>
> …
>
> [W]here the conduct in question is quite beyond anything contemplated as being involved in the taxpayer's duties, it will be very difficult to apply the test established in *Payne* in such a way as to render the outgoings deductible."

87 *Justification of the conclusion*: The foregoing conclusion can, in my opinion, be readily justified in the application of s 8-1(1)(a) to the circumstances of the present case:

- It gives effect to the decision and reasoning of this Court in *Payne* and to the longstanding earlier authority affirmed there;

- Once the focus of attention is placed, as *Payne* requires, on the "course" of the gaining or producing of the assessable income, it is fatal to the respondent's argument on the facts of this case. The alternative proposition, that all legal expenses incurred by officers are deductible, is mistaken. It would involve an entitlement to legal expenses (and possibly others) disjoined from "the course of" income gaining and producing activities. That is not only contrary to authority. It is alien to the ascertained purpose and intention of s 8-1(1)(a) of the ITAA. Logically, it would extend deductibility of legal expenses to cases of the kind mentioned by Spender J[163] (or to other purely private circumstances, such

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161 *Ronpibon* (1949) 78 CLR 47 at 56 cited in *Lunney v Commissioner of Taxation* (1958) 100 CLR 478 at 497.

162 (2007) 164 FCR 250 at 268 [78], 269 [84].

163 See (2007) 164 FCR 250 at 257 [35] per Spender J.

as a courier who becomes intoxicated in his own time and therefore risks losing his driving licence essential to his continuing employment). To allow deductibility in such cases would ignore the requirement of demonstrating a link to "the course of" the gaining or production of the assessable income. Once Spender J's alternative thesis is rejected, as *Payne* demands, the unlikelihood of allowing a deduction in circumstances such as the present is made clear;

- Any suggestion that, because the respondent was an officer of the Service, he thereby secured a special and privileged position for deduction of legal expenses should be firmly rejected. Many private employees face procedures if they are caught doing things extraneous to their employment. These may not involve procedures as formal as the statutory inquiry under the PSA but they may just as readily involve other procedures that occasion legal expenses to defend the employee's position. With respect, the distinction drawn in the joint reasons is not justified. It is certainly not desirable because it creates for a limited class of taxpayers a privileged position that is not spelt out in, or suggested by, the ITAA;

- As Dowsett J acknowledged, and as past decisions show, expenses incurred in the course of deriving assessable income will be deductible. Clear examples of such expenses are the legal costs incurred by a media publisher in defending defamation proceedings brought against it[164] (an ordinary expense of such a business) or legal costs incurred by a company obliged, exceptionally, to defend itself from public attack[165]. Securing legal representation in proceedings concerned with incompetence, negligence or even sometimes improper and wilful activity on the part of an employee might also attract deductibility by the *Payne* criterion. But in the uncontested facts of the present case, the requisite nexus is not established;

- Whatever may be the entitlement of the taxpayer in other cases, the respondent's legal expenses related to circumstances disjoined from "the course of" the income-producing activity. They were purely personal to the respondent. They were correctly so classified by the primary judge[166].

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164 *Herald & Weekly Times Ltd v Federal Commissioner of Taxation* (1932) 48 CLR 113 at 127; [1932] HCA 56.

165 *Federal Commissioner of Taxation v Snowden & Willson Pty Ltd* (1958) 99 CLR 431 at 437; [1958] HCA 23; cf *Magna Alloys and Research Ltd v Federal Commissioner of Taxation* (1980) 33 ALR 213.

166 *Day* (2006) 62 ATR 530 at 538.

Whilst it may be conceded that difficult and contestable decisions will occasionally fall to be decided by the application of the *Payne* criterion, the present is not such a case given that the respondent did not suggest that any of his conduct resulting in his legal representation, involved the course of the performance of his duties as a Customs officer; and

- If the foregoing conclusion is reached, derived from an application of s 8-1(1)(a) of the ITAA read in the light of *Payne*, the outcome causes neither inconvenience nor surprise. Inconvenience and surprise are considerations often taken into account to check the correctness of a statutory interpretation reached by a process of legal analysis. To the contrary, the opposite conclusion would cause surprise, and even astonishment. Whatever may be the justification of permitting deductions from assessable income for legal expenses necessarily incurred in the course of deriving the income, to provide such deductions where the "occasion" of the proceedings involving the legal representation had nothing to do with the course of the income-producing employment (or "office") appears fundamentally alien to the purposes of the deductions for which s 8-1(1)(a) of the ITAA provides.

88 Why, it might be asked rhetorically, should the revenue (and therefore effectively other taxpayers) support legal proceedings brought by a Customs officer in respect of conduct on his part which, if proved, was concededly unconnected with the performance of his functions and duties and wholly alien to such duties? This was not a case of an arguably relevant connection with "the course of" the respondent's income producing employment. The only connection was that of defending and protecting the income stream. Once that justification is set aside, as incompatible with the language of s 8-1(1)(a) as explained by *Payne*, the character of the deductions claimed is revealed in stark relief. There is no relevant connection between the assessable income and the expenditure[167]. The payment for the legal expenses was "independent of the production of the income, not an expenditure incurred in the course of its production"[168]. It therefore fell outside the positive limb of s 8-1(1). It follows that the deduction was correctly disallowed.

The negative limb – private losses or outgoings

89 There remains the Commissioner's alternative reliance on s 8-1(2)(b) of the ITAA. He argued that, if, contrary to his submission, a deduction arose under s 8-1(1)(a) it would nonetheless be disallowed by virtue of the disqualification

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167 *Amalgamated Zinc* (1935) 54 CLR 295 at 310.

168 (1935) 54 CLR 295 at 310.

expressed in s 8-1(2)(b) of losses or outgoings "of a private … nature". The interconnection between the two paragraphs is plain.

90 If I had been of the view (otherwise than by way of the inadmissible reasoning of defending the income stream) that the respondent's legal expenses were incurred in some way in the course of gaining or producing his assessable income, I would have concluded that such losses or outcomes were nevertheless of a private nature and so precluded from deduction.

91 Given the statutory dichotomy between outgoings incurred in gaining or producing assessable income (deductible) and outgoings of a private nature (non-deductible), the respondent's legal expenses fell on the "private" side of the line. The language and structure of s 8-1 of the ITAA supports this conclusion. Payment for legal representation to defend purely personal conduct is clearly of a "private" nature within the category stated in s 8-1(2)(b) of the ITAA. If it can somehow fall within the first (positive) limb of the section (as sub-s (2) necessarily postulates will sometimes occur), it nonetheless falls outside deductibility if its essential character is "private".

92 The situation might have been different if the basic facts were being contested by the respondent; or where some of them were disputed and others not; or where the respondent sought to throw a new and different light on his conduct or somehow to associate the conduct with "the course of" his duties as an officer. However, all such complications can be disregarded in the circumstances of the respondent's case. It was clear and simple. Either on the positive or negative limb of s 8-1(1) or (2) of the ITAA, the deductions were correctly disallowed by the Commissioner. It follows that on one or other of the Commissioner's arguments he was entitled to succeed.

Orders

93 Because of the conditions as to costs attached to the grant of special leave, the following orders should be made. The appeal from the judgment of the Full Court of the Federal Court of Australia should be allowed. Orders 1 and 2 of that court, made on 21 December 2007, should be set aside. In their place, this Court should order that the appeal to that court and the cross-appeal be dismissed. The appellant should pay the costs of the respondent in this Court.