

Sharpcan and Australia's Peculiar Treatment Of Capital Expenses

by Christina Allen and Richard Krever

Christina Allen is a doctoral candidate and Richard Krever is a professor with the University of Western Australia Law School in Perth.

In this article, the authors discuss a recent Australian High Court case and argue that Australia's legislative framework dictating the distinction between capital and current expenses is inadequate and poses unnecessary judicial roadblocks.

The High Court of Australia's October 16 decision in *Commissioner of Taxation v. Sharpcan Pty. Ltd.*, [2019] HCA 36, starkly illustrates the bizarre doctrines and inadequate legislative framework that govern the distinction between capital and current expenses in Australian tax law.

The facts of *Sharpcan* were relatively straightforward: The taxpayer operated a hotel pub and obtained gaming licenses allowing it to operate gambling machines for 10 years. The taxpayer no doubt amortized the cost of its 10-year licenses over a decade for accounting purposes, and the same result would follow under any benchmark income tax. However, that outcome was not possible in the Australian income tax regime, which has no general depreciation rule for expenditures on wasting assets. Instead, relying on selective common law doctrines that distinguish capital and current expenses, the taxpayer successfully argued before a first instance tribunal and again on appeal to the penultimate court of appeal that the outgoings were current — or, in Australian terminology, “revenue” — expenses, deductible in full when the multiyear licenses were first acquired.

Relying on the same judicial doctrines but characterizing the role of the expenses slightly differently as a contribution to the taxpayer's

business structure, the Australian Taxation Office prevailed at the High Court of Australia, which characterized the cost of acquiring the licenses as a capital expense. While that initial judicial characterization on its own was arguably an appropriate outcome in tax policy terms, in the context of the Australian rules for recognizing capital expenses, it led to a perverse outcome with the taxpayer only able to recognize the cost of the licenses as a capital loss in 10 years when the licenses expire, and then only if it has capital gains that can be offset against the deemed capital loss.

The treatment of ordinary business expenses should be one of the simplest aspects in any country's income tax system. But, as *Sharpcan* demonstrates so well, a tax regime built on inappropriate legal doctrines applied to an anomalous tax law structure can yield outcomes that are troubling in tax policy terms. At the same time, the decision illustrates the universal difficulty courts face in delivering fair outcomes when confronted with wholly unprincipled tax legislation.

The Legislative and Judicial Context

From its inception in 1915, Australian income tax legislation, like that of virtually all jurisdictions, has distinguished between revenue (or current) and capital expenses. Current expenses are deductible under a general deduction provision and capital expenses are recognized only if addressed by a specific deduction, cost base (basis), or depreciation provision. The only recognition for capital expenses in the first income tax act, and for several decades after, was a depreciation measure that applied to the cost of acquiring what became known as “plant and articles” — that is, tangible machinery, implements, and similar assets. The law provided no definition of capital expenses

and no guidance on what the legislature intended by denying deductions for all other capital expenses.

Australia has a common law system. In the absence of a legislative structure that might yield clues regarding the intended definition of capital expenses, judges charged with interpreting the term in appeals of income tax assessments relied on a technique called the "transplanted category" procedure. Judges simply extend the scope of a precedent to use a settled understanding in one area of law when interpreting the same term found in a later and different law. That approach in other areas of income tax law has led to, for example, a judicial notion of employee for withholding tax on remuneration purposes that is built almost entirely on the judicial definition of employee created in the previous century for vicarious liability in tort law. Similarly, the judicial determination of when income can be transferred for tax purposes in Australian revenue law derives directly from property concepts in the much older law of equity.

To identify capital expenses for income tax purposes, Australian courts first looked at older U.K. precedents considering the capital or revenue character of outgoings for U.K. income tax purposes. Those were derived from U.K. trust law tests that had been developed to distinguish expenses that were to be charged against the interests of life or income beneficiaries of a trust and those that were to be charged against the interests of remainder or capital beneficiaries of the trust. For many decades, the primary factors considered by courts when determining the revenue or capital nature of an expense were the longevity of the benefit acquired, the frequency with which the taxpayer made similar acquisitions, and the manner in which the taxpayer paid for the acquisition (lump sum or periodic payments). Those parallel tests were eventually consolidated into one primary test that remains in effect today, looking at whether the expenditure is related to the structure of a taxpayer's business (in which case it is considered a capital expense) or the income-earning process of the taxpayer's business (in which case it is characterized as a revenue expense).

The exact meanings of the structure and process concepts are obscure and, unsurprisingly,

outgoings often received differing characterizations as assessments worked their way up the appeal court ladder, and at any one level often resulted in both majority and minority opinions. The uncertainty caused by the ambiguous tests is reflected in one of the most-cited judicial quotes in Australian deduction cases, the words of a U.K. judge who observed, "[I]n many cases it is almost true to say that the spin of a coin will decide the matter almost as satisfactorily as an attempt to find reasons."¹

For the first seven decades of income taxation in Australia, expense characterization by courts took place in the context of a remarkably narrow income tax base. Using parallel trust law doctrines on the income side to characterize expenses, courts decided in the early years of Australian income taxation that income subject to assessment under the law was akin to receipts that would accrue to a life beneficiary of a trust, while capital gains, being the income payable to a capital or remainder beneficiary when derived from a trust, sat outside the scope of income tax law. It was exactly 70 years before capital gains and losses were added to the income tax base.

With capital gains and losses excluded from the tax base by judicial doctrine, the only path to recognition of capital expenses was fitting the outgoings into the depreciation regime. That, however, was limited to the cost of acquiring tangible plant and articles, leaving taxpayers with no way to recognize most capital expenses. Over time, lobbying efforts led to the addition of separate depreciation regimes for other wasting assets such as agricultural structures, hotels and motels, and telecommunications spectrums. The number of separate regimes reached a few dozen before they were finally consolidated into a smaller number as part of a business tax reform at the turn of this century.

The depreciation regimes adopted in response to industry lobbying were specific and narrow. That left a large range of expenditures outside the depreciation rules, and in the absence of any rules bringing capital gains and losses into the tax base, judges hearing appeals on the character of outgoings were often left with an all-or-nothing

¹Sir Wilfred Greene MR in *Inland Revenue Commissioners v. British Salmon Aero Engines Ltd.*, [1938] 2 KB 482, 498.

choice. If the expense was characterized as a revenue expense, it could be deducted immediately even if the benefit lasted for years, while if labeled capital, it could never be recognized even if it had a short and known finite life.

As the judicial doctrines evolved, the characterization of particular types of expenses shifted. Expenses incurred to defend title to an asset, for example, were originally characterized as immediately deductible expenses but later viewed as nondeductible capital expenses applying the income-earning process versus income-earning structure test. Expenses incurred to keep potential competitors out of the field were also once treated as deductible revenue expenses and later as nondeductible capital outlays. Outcomes were often counterintuitive. In one case, the cost of demolishing an obsolete steel yard that provided no ongoing benefit was treated as a nondeductible capital expense related to the taxpayer's structure,² while in another the cost of obtaining a 15-year contract was characterized as a currently deductible revenue expense.³ In a third case, the cost of obtaining a shorter 10-year exclusivity agreement was treated as a nondeductible capital expense.⁴

The inclusion of capital gains in the income tax base in 1985 made it possible for taxpayers to recognize a limited class of capital expenses if the expenditure was for an identifiable wasting asset such as a fixed-term contract or the acquisition of rights for a limited period. In those cases, after 1985 the cost of acquisition could be recognized as a capital loss on the disposal of the rights acquired or on their expiry at the end of the agreement. Taxpayers were also allowed to add previously nondeductible expenses incurred to defend their title to an asset to the asset's basis and eventually recognize the expense if there was a later disposal of the asset.

Remaining outside the tax law were capital expenses that yielded no asset, such as business closure costs or expenses incurred to oppose

applications by potential competitors to carry on business. They became known as "black hole" expenses: legitimate business expenses incurred to derive gross income that fell into a black hole for tax purposes as a result of their capital expense designation. Recognition of some of the black hole expenses such as costs associated with business closure came with the 2001 adoption of yet another depreciation regime, labeled the "black hole depreciation system" by practitioners, which provided a five-year write-off for business start-up and closure expenses and some similar expenses. The black hole depreciation regime was augmented in 2006 to bring in all remaining capital expenses that fall outside other depreciation rules apart from expenses that form part of the cost base of assets for capital gains purposes unless the sole purpose of the expense is to preserve the value of the taxpayer's goodwill.

Sharpcan and the Revenue-Capital Divide

Relying on an argument that the acquisition of gaming licenses was linked to its existing hotel pub business and thus connected to an ongoing income-earning process that made the cost of the acquisition a deductible current expense, the taxpayer in *Sharpcan* filed a return that included a deduction for the licenses. The ATO denied the taxpayer the deduction it sought, and the taxpayer appealed the assessment. A first instance tribunal accepted the taxpayer's income-earning process argument, as did a majority of the three judges hearing the ATO's subsequent appeal to the full Federal Court.⁵ The dissenting appeal judge viewed the outlay as a capital expense — that is, the cost of acquiring wasting assets, which related to the structure of the taxpayer's business, not the income-earning process. Anticipating the possibility that the appeals court might find the expense to be of a capital nature, the taxpayer's fallback argument was that if the expense were capital, it was incurred to preserve the value of the taxpayer's business goodwill and thus depreciable over five years under the black hole depreciation rule. The dissenting judge also rejected that argument.

² *Federal Commissioner of Taxation v. The Broken Hill Proprietary Company Ltd.*, [1968] HCA 16.

³ *National Australia Bank Ltd. v. Federal Commissioner of Taxation*, [1997] FCA 1394.

⁴ *Jupiters Ltd. v. Deputy Commissioner of Taxation*, [2002] FCAFC 206.

⁵ *Sharpcan Pty. Ltd. v. Commissioner of Taxation*, [2018] FCAFC 163, aff'g [2017] AATA 2948.

The ATO appealed to the High Court of Australia. All five judges hearing the appeal agreed with the ATO's argument that the expense was incurred to acquire an asset that was connected with the structure of the taxpayer's business, not its current income-earning process, giving it a capital character. The Court also concluded that the acquisition of the gaming licenses did not merely preserve the hotel pub's existing goodwill but also provided the taxpayer with a source of revenue, meaning the expense could not be depreciated over five years under the black hole depreciation regime.

Thus, the taxpayer in *Sharpcan* will be entitled to recognize the cost of acquiring its gaming licenses when they expire in 2022, 10 years after acquisition. The expenses are treated as the basis of assets that will be disposed of for consideration of zero when they expire, yielding a capital loss equal to the original cost. The taxpayer will be able to use any capital losses only if it has offsetting capital gains in 2022 or a future year.

Conclusion

The case is the latest in a long line of decisions that expose a fundamental flaw in the design of

Australia's income tax laws: the absence of a general depreciation rule for wasting assets. Time and again expenses for wasting assets fall through the gaps in depreciation rules and can be recognized as capital losses only once the wasting assets are fully used or expired. Policy experts have long argued that the optimal reform would be to adopt a single rule that allows taxpayers to deduct the cost of wasting assets over the lives of those assets.⁶ If desired, the legislature could supplement the basic rule with tax expenditures that provide accelerated deductions or even immediate write-offs while maintaining the integrity of the basic rule.

Taxpayers have waited more than a century for more rational rules for the recognition of expenditures for wasting assets. Judges, too, would no doubt welcome a system that allowed them to make principled decisions consistent with the objective of the law. *Sharpcan* provides yet another graphic illustration of the system's flaws. ■

⁶Greg Pinder, "The Coherent Principles Approach to Tax Law Design," *Economic Roundup* 75 (Autumn 2005).