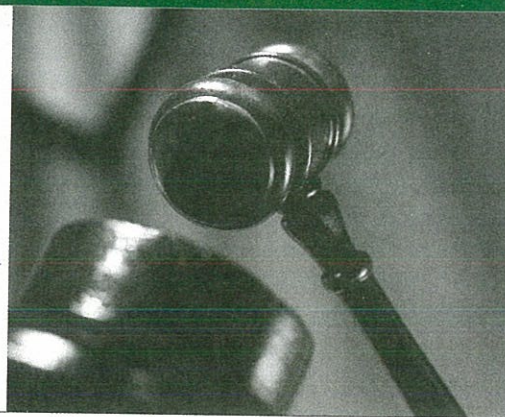


Deductibility of employee legal costs in enforcing a terminated employment contract

ROMANIN V THE COMMISSIONER OF TAXATION [2008] FCA 1532.



INTRODUCTION

Romanin v The Commissioner of Taxation (Romanin) is a decision of a single judge of the Federal Court relating to whether an item of expenditure is an allowable deduction. Mr Romanin claimed legal fees incurred by him in enforcing his rights under an employment contract were deductible on revenue account. He received a lump sum additional payment from his former employer in lieu of notice some time after the termination of his employment. The Commissioner did not allow the legal costs as a deduction. As will be seen, the Federal Court allowed the deduction on the basis that the legal proceedings in which the expenses arose were connected to the taxpayer's employment and therefore should be allowed.

This case is a timely reminder of when it is permissible to claim deductions in relation to legal expenses incurred by a taxpayer in relation to his or her employment.

BACKGROUND FACTS

In June 1999, Mr Romanin (**Taxpayer**) was recruited on a temporary basis as the General Manager and Company Secretary for the University Co-operative Bookshop Limited (**Co-op**). Soon after, the Taxpayer commenced negotiating permanent employment with the Co-op. During these negotiations, the Taxpayer stated that he was not willing to accept permanent employment until he received confirmation from the Chairman of the Co-op that he would be entitled to 12 months' notice of termination or payment in lieu if his employment was terminated.

By letter dated 20 August 1999, the Co-op offered the Taxpayer permanent employment and confirmed the terms of his appointment, based on a salary of \$244,000 per annum. His entitlement to 12 months' notice of termination or payment in lieu was not specified in the letter from the Co-op. After further discussions, it was confirmed verbally that the Taxpayer would be entitled to his requested notice period or payment in lieu. On this basis, the Taxpayer accepted the appointment with the Co-op.

At the time the Taxpayer commenced employment, he had not signed a written contract of employment. A draft service agreement was provided to the Taxpayer on 15 September 1999. However, it only provided for six months' notice of termination. When the Taxpayer brought this inconsistency to the attention of the Co-op, the Co-op denied that the original arrangement had ever existed.

In October 1999, the Co-op terminated the Taxpayer's employment, giving only seven days' notice. The Taxpayer eventually found alternative employment in the 12 months following the termination of his employment. The Taxpayer earned a total of \$144,983.51 in that period.

A later decision of the Industrial Relations Commission confirmed that the Taxpayer had a binding and enforceable employment contract with the Co-op, such that the Taxpayer was entitled to 12 months' notice of termination of his employment or payment in lieu. As a result, the Co-op was ordered to pay the Taxpayer the sum of \$202,829.90, being an amount equivalent to his earnings under the employment contract plus interest,

less the amount earned by the Taxpayer in alternate employment.

In February 2004, the Taxpayer was advised to treat the sum of \$202,829.90 (**Lump Sum**) as an eligible termination payment. Accordingly, this amount was included in the Taxpayer's tax return as assessable income (less an amount of \$40,000 that the Taxpayer rolled over into his superannuation fund).

In addition, in the financial year ended 30 June 2005, the Taxpayer was offered an additional amount of \$210,000 in part payment of his legal fees which totalled \$283,565.14 (**Expenses**). The Taxpayer had claimed the Expenses as a deduction from his assessable income during the years in which the Expense arose, namely the 2000-04 income years.

In 2006, the Commissioner audited the Taxpayer and concluded that the legal expenses claimed were not allowable deductions. The Commissioner issued amended assessments for the 2000-04 income years to which the Taxpayer objected. On 16 November 2007, the Commissioner disallowed the Taxpayer's objection. The Taxpayer appealed to the Federal Court.

LEGISLATION

Section 8-1 of the *Income Tax Assessment Act 1997 (Cth)* (**ITAA97**) provides in relation to general deductions:

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

- (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:
- it is a loss or outgoing of capital, or of a capital nature; or
 - it is a loss or outgoing of a private or domestic nature; or
 - it is incurred in relation to gaining or producing your exempt income or your non-assessable non-exempt income; or
 - a provision of this Act prevents you from deducting it.

Section 20-20(2) ITAA97 addresses payments that constitute assessable recoupments in relation to insurance or indemnities such that an amount you have received as recoupment of a loss or outgoing is an assessable recoupment if:

- you received the amount by way of insurance or indemnity; and
- you can deduct an amount for the loss or outgoing for the current year, or you have deducted or can deduct an amount for it for an earlier income year, under any provision of this Act.

Where a payment is an assessable recoupment, s 20-35 ITAA97 provides that a taxpayer's assessable income includes an assessable recoupment of a loss or outgoing if the whole of the loss or outgoing can be deducted in the current year, or has been deducted in an earlier year.

ISSUES BEFORE THE FEDERAL COURT

The Taxpayer asked the Court to determine whether the Expenses claimed by the Taxpayer in the income years 30 June 2000 to 30 June 2004 were allowable deductions.

Taxpayer's submissions

The Taxpayer submitted that the Expenses were deductible against the Taxpayer's assessable income pursuant to s 8-1 of the ITAA97.

- A wide interpretation should be given to the expression "incurred in gaining or producing assessable income" contained in s 8-1 of the ITAA97. Accordingly, the Expenses were incurred by the Taxpayer in enforcing

a contractual payment of income arising from his employment under a contract with the Co-op and should therefore be deductible.¹

- In reliance of the decision of *Commissioner of Taxation v Day*,² the Expenses are deductible because they were incurred in respect of proceedings instituted to defend the income earning ability of the Taxpayer.
- The character of the Expenses incurred is revenue in nature and not capital and should not be disallowed under s 8-1(2) of the ITAA97.

Positive limb of Section 8-1: nexus between income and expense

The Court considered a long line of cases to determine whether there was a sufficient nexus, for the first limb of s 8-1 of the ITAA97, between the loss or outgoing and the generation of assessable income by the Taxpayer, including the cases of *Sun Newspapers Limited v Federal Commissioner of Taxation*,³ *Ronpibon Tin NL and Tongkah Compound NL v Federal Commissioner of Taxation*⁴ and *Amalgamated Zinc (De Bavay's) Ltd v Federal Commissioner of Taxation*.⁵

“ Had [Mr Romanin] not incurred that expense, the payment and the tax on the payment would not have eventuated. There is a direct “but for” causation applicable.⁶ ”

Commissioner's submissions

The Commissioner submitted that the Expenses were not deductible under s 8-1 of the ITAA97.

- The Expenses were not "incurred" in the course of deriving assessable income from undertaking the duties of his employment as the employment had ceased.
- Even if the Court found that Expenses were deductible under s 8-1, they ought be excluded by s 8-1(2)(a) as they are capital in nature.
- In the alternative, if the Expenses are held to be deductible, then the amount recovered by the Taxpayer from the Co-op in satisfaction of the costs order (in the amount of \$210,000) ought be classified as an "assessment recoupment" under s 20-20 of the ITAA97 as it was received by way of indemnity. The whole of this amount should then be included in the Taxpayer's assessable income for the 2005 income year pursuant to s 20-35 of the ITAA97.

These cases stand for the proposition that the expenditure forming the allowable deduction must be "incidental and relevant"⁷ to the gaining or producing of assessable income. Notwithstanding this, the Court relied heavily on the reasoning of Edmonds J in the decision of *Day*,⁸ where his Honour found that a test of incidence and relevance cannot be as easily applied to expenses incurred in defending legal proceedings because the decision to defend those proceedings is "divorced from the activities of producing that income". As a result, Edmonds J reasoned that the appropriate test in relation to legal expenses is whether the expenditure was incurred in the course of gaining or producing assessable income, in the sense that the occasion of the expenditure is to be found in what produced the assessable income in the first instance.

The Court held that it was not necessary that the legal proceedings related to the **activities** of the Taxpayer's employment for those expenses to be deductible under s 8-1 of the ITAA97.⁹ From an objective point of view, the goal that the Taxpayer had in view when he incurred the Expenses was to defend a contractual entitlement

to income from his previous employer. In the Court's opinion, such a link gave rise to a sufficient nexus between the expense and the producing of assessable income to satisfy the positive limb of s 8-1 of the ITAA97.

The Court rejected the Commissioner's contention that the Expenses did not relate to the process whereby the Taxpayer carried out duties to produce income under his former employment arrangement. The Court stated that such an argument is difficult to accept in circumstances where payment constitutes enforcement of an entitlement to income, rather than compensation or damages.

Negative limb of Section 8-1: domestic or capital nature

The Court considered the Expenses claimed by the Taxpayer in light of the test outlined by Dixon J in *Sun Newspapers*, being:

- (a) the character of the advantage sought,
- (b) the manner in which the payment is to be used, and
- (c) the means adopted to obtain it.

The Commissioner argued that the Taxpayer was not pursuing recovery of income but rather a lump sum payment by way of relief for termination of his employment contract, and in this regard, the payment should be treated as capital. As a result, it would not be an allowable deduction under s 8-1 of the ITAA97. The Court did not accept this argument. Instead, the Court held payment of income, as a lump sum in lieu of regular payments does not, in and of itself, change the character of the payment.

The Court also rejected the Commissioner's alternative contention that the payment made by the Co-op in respect of the Taxpayer's costs should be regarded as an "assessment recoupment" under s 20-20 of the ITAA97 because there was no evidence before the court of whether the Taxpayer had in fact received reimbursement for his loss, or if he had received the reimbursement, when it was received. The Court accepted that the Taxpayer must allow for the receipt of those costs in his taxable income at some point.

DECISION OF THE FEDERAL COURT

The Court found for the Taxpayer, deciding that the Expenses that he incurred in the proceedings against his previous employer were deductible under s 8-1 of the ITAA97 because there was a sufficient nexus between the expenses and the gaining or producing of the assessable income of the taxpayer. Furthermore, the Expenses were not of a capital or domestic nature. The Court rejected the argument that the payment made by the Co-op in respect of the Taxpayer's costs could be regarded as an assessment recoupment in accordance with s 20-20 of the ITAA97 because of lack of evidence.

CONCLUSION

In *Romanin* the Commissioner appeared to take the view that the decision of the Full Federal Court in *Commissioner of Taxation v Day* [2007] 164 FCR 250 was wrong. This was subsequently borne out by his unsuccessful appeal to the High Court in *Day*.¹⁰ *Day* was a case which dealt with the deductibility of legal expenses incurred by an officer of the federal public service (Day) in defending charges brought against him under the *Public Service Act 1922*. Day needed legal assistance to defend the charges and to preserve his position.

The High Court, by a majority, found that the legal expenses were deductible because Day's actions as an officer of the public service, and the possible consequences to him of internal disciplinary proceedings and action with respect to the continuation or termination of his service formed part of what was productive of his assessable income in that capacity.

However, in *Romanin*, unlike *Day*, which dealt with current employment, it was necessary to and the Court did find a connection between the receipt and the taxpayer's former employment. Further, the Court drew a distinction between monies received as compensation and those received under a contractual right. In this regard, the Court has taken a broad interpretation of the acceptable connection required between an expense and assessable income. This is no more than Dixon J in *Amalgamated Zinc*¹¹ held to be the correct approach in relation to deductibility:

"a very wide application should be given to the expression 'incurred in gaining or producing the assessable income'".

If the Commissioner was attempting to use *Romanin* to limit the effect of *Day*, he failed.

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Reference notes:

- 1 *Romanin* [25].
- 2 [2007] 164 FCR 250.
- 3 (1938) 61 CLR 337.
- 4 (1949) 78 CLR 47.
- 5 (1935) 54 CLR 295.
- 6 *Above n 1*, at [44].
- 7 *Ronpibon Tin and Amalgamated Zinc above n 4 and 5*.
- 8 *Above n 2*, at [91] - [101].
- 9 *Above n 1*, at [52].
- 10 [2008] HCA 53.
- 11 *See above n 5*.