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Self Education Expenses and Receipts : Implications for Income Taxation and FBT in Light of FCT v MI Roberts

Abstract

This comment discusses the law relating to the assessability of self-education receipts, the deductibility of self-education expenses and the implications of the Fringe Benefits Tax ('FBT'). Analysis focuses on the recent decision of FCT v MI Roberts.

Keywords

self-education expenses, taxation, fringe benefits tax

SELF EDUCATION EXPENSES AND RECEIPTS : IMPLICATIONS FOR INCOME TAXATION AND FBT IN LIGHT OF *FCT v MI ROBERTS*¹

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This comment discusses the law relating to the assessability of self-education receipts, the deductibility of self-education expenses and the implications of the Fringe Benefits Tax ("FBT"). Analysis focuses on the recent decision of *FCT v MI Roberts*.

Assessable income and education receipts

The Income Tax Assessment Act 1936 (Cth) ("ITAA") provides that income derived from a "scholarship, bursary or other educational allowance" to full-time students shall be exempt from income tax. This exemption only applies if the scholarship or other receipt is not conditional upon the rendering of services to the provider of the payment.²

Receipts in light of the recent draft ruling by the Commissioner

A recent draft ruling issued by the Commissioner offers a somewhat controversial interpretation of s 23(z)(i). Draft Taxation Ruling TR94/D13 says that providing a service for the purposes of this section includes the assigning of intellectual or corporeal property rights for

¹ *FCT v MI Roberts* 92 ATC 4787.

² ITAA s 23(z)(i), which provides as follows: "Income derived by way of a scholarship, bursary or other educational allowance or other educational assistance [received] by a student receiving full-time education at a school, college or university, but not including ... an amount received by a student from a person or authority upon condition that the student will (or will, if required) render, or continue to render, services to that person or authority [shall be exempt from income tax.]"

original work undertaken pursuant to the scholarship.³

In other words, according to this draft ruling, the publishing intention of the university or institution which provides a scholarship could be enough to remove the s 23 exemption for the student.⁴ It is often a standing requirement of university scholarships that the university retains intellectual property rights in the products of the student's work. This interpretation of the Commissioner is likely to greatly restrict the scholarships that are offered if the provider is unable to claim any rights over the holder's work. Alternatively, if the scholarship is fully assessed to income tax, the number of high calibre students who are able to accept such scholarships will become limited. At a time when Australia ought to be encouraging innovation, and when we are urged to become the "clever country",⁵ this draft ruling by the Commissioner seems counter-productive.

Other receipts for self-education

In addition to s 23(z) scholarships, other gifts in relation to study have also been exempted from income tax. In *Smith v FCT*⁶ a payment made by an employer to an employee upon completion of a program under an "encouragement to study scheme" was held not assessable to income tax. The payment was not sufficiently connected with the recipient's employment. It was not conditional upon the performance of services to the employer, and was characterised as a gift from employer to employee.

Education grants, then, passing from employers to employees who are studying, are likely to be taxed if there is some obligation or service to be rendered as a condition or consequence of the payment. If a payment has no obligation or condition attached to it,⁷ and is not a product or incident of the recipient's employment,⁸ it will not form part of the taxpayer's assessable income. There was a separate question in this case with respect to the liability of Smith to fringe benefits tax. This is discussed later in this comment.

³ Draft Taxation Ruling TR 94/D13 at 11.

⁴ (1994) 15 *CCH Tax Week* 193 at 194.

⁵ Beyer V, "A tax incentive for the clever country?" 2 *Revenue LJ* 70 at 70.

⁶ *Smith v FCT* (1985) 16 *ATR* 1035.

⁷ *Ibid* at 1042 per Yeldham J.

⁸ *Hayes v FCT* (1956) 96 *CLR* 47 at 56-57 per Fullagar J; *Scott v FCT* (1966) 117 *CLR* 514 at 525-526 per Windeyer J.

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Deductions and education expenses

Education expenses will be deductible under s 51(1) ITAA if they are

incurred in gaining or producing assessable income, or are necessarily incurred in carrying on a business for the purpose of gaining or producing such income...⁹

The outgoings must show some nexus with the scholar's assessable income.¹⁰ The traditional test is whether the expenditure is "incidental and relevant"¹¹ to the producing of assessable income. This rather formless test was applied to self education expenses in *FCT v Finn*.¹² A recent case dealing with this formula is *FCT v MI Roberts*¹³ which is considered in detail later.

FBT and education expenses and receipts

Education expenses paid for employees are not specifically caught under the Fringe Benefits Tax Assessment Act ("FBTAA"), but they do fall under Division 5 of the FBTAA as Expense Payment Fringe Benefits or under Division 12 of the FBTAA as Residual Fringe Benefits. Under s 20 FBTAA, any payments by an employer of an employee's expenses or reimbursement of an employee's expenses are considered fringe benefits and are assessable to FBT. This would cover education benefits.

However, if an expense would otherwise be deductible by the recipient under s 51(1) ITAA, any liability to FBT will be reduced to nil.¹⁴ This means that the tests to determine the deductibility of self-education expenses for the purposes of income tax are applicable in determining liability for FBT.

Education expenses, such as the cost of in-house education programs paid by employers, will not be subject to FBT as they fall within the second limb of s 51(1) as "ordinary business expenditure", and accordingly any liability will be reduced to nil. Such expenses are encompassed within the "otherwise deductible" rule. They are incurred so that the recipient can maintain their knowledge and skill in their

⁹ Section 51(1) ITAA.

¹⁰ Woellner, Vella and Burns, *Australian Taxation Law* (4th ed 1993) 696.

¹¹ *Rompibon Tin NL v FCT* (1949) 78 CLR 47 at 56-57.

¹² *FCT v Finn* (1961) 106 CLR 60 at 67.

¹³ Above n 1.

¹⁴ Section 24 FBTAA. See further Woellner, Vella and Burns, *Australian Taxation Law* (4th ed 1993) 401.

profession.

The initial \$250 of self education expenses are not deductible, pursuant to s 82A ITAA. However, s 24(1)(b)(iii) of the FBTAA states that s 82A of the ITAA does not apply to fringe benefits. The effect of this section is to ensure that, if an expense was incurred in self education and deductible, the first \$250 of that expense is not assessable for FBT. In the alternative, if the expense is not considered deductible for self education, FBT is payable on the whole amount.

The payment in *Smith* was not assessable for FBT under the "former" fringe benefits provision, s 26(e) ITAA. An honorarium was paid over and above the costs incurred in undertaking self education, and was not conditional on any services performed by the employee. Therefore, it was not income assessable under s 26(e). There was insufficient connection between the employment and the study grant. If there is a connection between the employment and the payment, then the employer will be liable to FBT.

FCT v MI Roberts

Summary of facts

In *FCT v MI Roberts*¹⁵ the taxpayer was a professional mining engineer who had been encouraged to gain further qualifications in management. He applied to, and was accepted into, an MBA program at a university in the United States. In July 1988, the taxpayer's employer retrenched him, with his consent, just prior to the commencement of his study in the USA. The taxpayer had prior discussions with another mining company with a view to possible employment after completing his studies. He gained no guarantee of future employment. After completing his studies, the taxpayer commenced employment as General Mine Manager with that other mining company. This position carried a considerably increased salary. The Commissioner disallowed deductions for the taxpayer's self-education expenses incurred whilst studying in the USA. The Administrative Appeals Tribunal upheld the taxpayer's objection. The Commissioner then appealed to the Federal Court.¹⁶

¹⁵ Above n 1.

¹⁶ *Ibid* at 4787-4789.

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Analysis of the case

In the Federal Court, Cooper J concluded that there was no nexus between the outgoing of the taxpayer and the gaining or production of assessable income as required by s 51(1) ITAA. His Honour stated that, "the expenditure in the present case falls squarely within the statements of Barwick CJ and Menzies J in *Maddalena*".¹⁷ In that case, Barwick CJ held:

the cost to an employee of obtaining his employment does not form an outgoing incurred in the course of earning the wages payable in the employment.¹⁸

In *Roberts* the taxpayer was changing from one job to another. One job was concluded upon resignation, a new qualification was gained and then a new job was commenced. The statement of Barwick CJ applies to this situation.

In addition, Menzies J in *Maddalena* stated that the expenditure occurred too soon for the taxpayer to be engaged in business activities - it was expenditure in preparation for business.¹⁹ At the time the expenditure was incurred, the taxpayer in *Roberts* was not employed. Following *Maddalena*, it could be argued that Roberts' expenditure was preparatory to the earning of assessable income as opposed to expenditure incurred in "gaining or producing" assessable income.

Cooper J further substantiated his finding by following the reasoning of Ormiston J in *FCT v Klan*.²⁰ Ormiston J cited *Maddalena* as being directly relevant.²¹ In *Klan*, Ormiston J held that the expenses of a teacher who gained further experience in England, to increase his chances of becoming a headmaster of an Australian school, were not deductible, because they were related to obtaining a new position.²² The taxpayer had expended the money as "a means of obtaining a contract of employment with a new employer."²³ This was also the situation in *Roberts*. The costs of the MBA were costs related to obtaining a new position. They were not "incidental and relevant to operations and activities carried on for the earning of assessable

¹⁷ Ibid at 4798.

¹⁸ *FCT v Maddalena* 71 ATC 4161 at 4162.

¹⁹ Ibid at 4163.

²⁰ *FCT v Klan* 85 ATC 4060 at 4068, followed by Cooper J in *FCT v MI Roberts* 92 ATC 4787 at 4798.

²¹ *FCT v Klan* 85 ATC 4060 at 4068.

²² Ibid.

²³ Ibid.

income.²⁴ These were considered to be expenses incurred in *getting work*.

The situation of the taxpayer in *Roberts* may be similar to that of the taxpayer in *FCT v Finn*. However, *Roberts* satisfied only two of the four criteria set down in *Finn*, by Dixon CJ, for determining whether the expenditure was incurred in gaining or producing assessable income. The four criteria are firstly, that the knowledge gained must increase the likelihood of advancement for the taxpayer. Secondly, the study must be taken on for the purpose of advancement. Thirdly, the taxpayer's study must be of real advantage to her/him and to her/his work. Fourthly, the taxpayer must remain employed while undertaking the study.²⁵

The taxpayer in *Roberts* failed to show that the knowledge gained would increase the likelihood of advancement in his profession, as the attaining of such knowledge was only "well regarded".²⁶ Furthermore, the taxpayer was not employed during the time he spent studying. Although his motive for undertaking the study was to increase his assessable income and he was encouraged by potential employers to undertake the study, the taxpayer still failed to satisfy two of the criteria governing such a deduction. *Roberts* can be convincingly distinguished from the *Finn*.²⁷

The taxpayer in *Roberts* could, however, seek to rely on the judgment of Windeyer J in *Finn*. Windeyer J stated that a taxpayer who:

incurs expenses in maintaining or increasing his knowledge ...
incurs those expenses in carrying on his profession or calling.²⁸

Such a statement goes further than the other judgments in *Finn*. However, subsequently these words have been limited to the second limb of s 51(1), which was not in issue in *Roberts*.²⁹ Despite this, Cooper J neither accepts nor distinguishes Windeyer J's remarks in *Finn*.

A case similar on the facts to *Roberts* is *FCT v Hatchett*.³⁰ There, Menzies J, sitting alone in the High Court, relied on *Finn* as his

²⁴ *Ibid.*

²⁵ Above n 12 at 67.

²⁶ Above n 1 at 4791.

²⁷ See comments of Ormiston J in *Klan v FCT* 85 ATC 4060 at 4065 and 4067.

²⁸ Above n 12 at 70.

²⁹ See discussion by Menzies J in *FCT v Hatchett* 71 ATC 4184 at 4188.

³⁰ *Ibid.*

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primary authority. The taxpayer in *Hatchett*³¹ claimed a tax deduction for university fees incurred in studying to attain a higher qualification. The fees were not deductible because there was no "connection between the payment of the fees and the assessable income of the taxpayer".³² The fact that the university studies were likely to make the taxpayer a better teacher, and therefore more likely to earn him promotion and an increased salary, was not enough to make the fees deductible. A "perceived connection between the outgoing and the assessable income"³³ was lacking.

The taxpayer's failure to pass the subjects undertaken and the consequent remoteness of any present or future benefit was also relevant in *Hatchett*.³⁴ In *Roberts* all subjects were passed and thus a future benefit could have been possible. Furthermore, the taxpayer's motivation in *Roberts* was to increase his assessable income. The distinguishing fact was that, unlike in *Hatchett*, the taxpayer in *Roberts* was not employed by anyone at the relevant time.

Not all commentators are pleased by this line of reasoning. Yap³⁵ singles out *FCT v Studdert*³⁶ as authority for the proposition that:

a factual finding that a motivation for undertaking the course of study was to improve the taxpayer's proficiency at his job may be sufficient to ground a conclusion in favour of deductibility.

Applying this purpose-style test could have led to a different result in *Roberts*. However in *Studdert*, unlike *Roberts*, the taxpayer was employed at all material times.

Burgess³⁷ points to the purpose test applied in *Ure v FCT*³⁸ and *FCT v Ilbery*³⁹ as being relevant in determining whether expenses are deductible under s 51(1). This test, with its admirable and workable simplicity, states that losses or outgoings are deductible if they are incurred for the purpose of gaining or producing assessable income. Taxation Ruling TR 92/8 recognises the purpose test:

³¹ Ibid.

³² Above n 30 at 4187.

³³ Ibid.

³⁴ Butterworths Australian Tax Practice at [51/1160].

³⁵ Yap, "Deductions for self-education expenses pursuant to sec 51" (1992) *CCH Journal of Australian Taxation* 43 at 45.

³⁶ *FCT v Studdert* 91 ATC 5006.

³⁷ Burgess, "Deductions for Professionals" (1988) 23 *Taxation in Australia* 229 at 229-230.

³⁸ *Ure v FCT* (1981) 11 ATR 484.

³⁹ *Ilbery v FCT* (1981) 12 ATR 563.

D Baxby and D Brash Self-education Expenses

The intention or purpose of a taxpayer in incurring the self education expenses can be an element in determining whether the expenses can be characterised as allowable under subsection 51(1).⁴⁰

Applying the purpose test to the facts in *Roberts*, it appears that the expenditure would have been deductible. Both the subjective and objective purpose of the taxpayer in expending money on the tertiary study was to gain a higher assessable income. Cooper J did not overtly apply the purpose test in his judgment. To do so could have altered his decision, as it is well established that this year's costs may well be deductible this year, even though they only produce income in later years.⁴¹

*FCT v Kropp*⁴² decided the initial moving expenses of an accountant, who had resigned his job in Australia to take up an opportunity in Canada, were deductible under s 51(1). As with *Roberts*,⁴³ the taxpayer in *Kropp* actually resigned from his job. Cooper J distinguished *Kropp* on the basis that it fell into the category of someone who spent money to earn more money, in reliance on his conditions of employment. His Honour expressly adopted the words of Ormiston J in *Klan*:⁴⁴

[Although it] was not, strictly speaking, a condition of his employment that, if, having resigned his Australian position, he spent money overseas to work with the firm's international affiliates, his employer would re-employ him in a better position and his prospect for promotion would be significantly enhanced, ... it seems to me, that that was the practical effect of the standard arrangements and practices of the firm vis-a-vis its employees.⁴⁵

There are a number of features that distinguish *Kropp* from the decision in *Roberts* and support the above reasoning. Firstly, the taxpayer in *Kropp* was hired by an affiliated firm in Canada and was then re-hired by the same Australian employer. Such a situation did not occur in *Roberts*.

Secondly, in *Kropp* the staff partner in the Australian firm made arrangements, "for him to be employed with the Canadian Price

⁴⁰ Taxation Ruling TR 92/8 (CCH Australian Income Tax Rulings 15,168 at 15,174).

⁴¹ See, eg, *FCT v Osborne* 90 ATC 4889.

⁴² *FCT v Kropp* 76 ATC 4406.

⁴³ Above n 1.

⁴⁴ Above n 21 at 4067.

⁴⁵ Above n 1 at 4797.

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Waterhouse and Company ... from about the first of August 1972".⁴⁶ Such an arrangement contrasts with what occurred in *Roberts*. In *Roberts*, discussions were held that "were promising" for the taxpayer, but which did not include any "firm promise of employment."⁴⁷

Thirdly, in *Kropp* there was evidence that the firm strongly encouraged overseas trips at the taxpayer's own expense and that such trips would almost certainly involve re-employment at a higher salary and position.⁴⁸ In *Roberts* the taxpayer had an indication that an MBA, "would be well regarded," but would, "not guarantee future employment."⁴⁹

Finally, in *Kropp* the taxpayer had taken the accrued holiday pay owing, but had not taken the superannuation benefit. This was a further indication the taxpayer would eventually return to the same employer. No evidence points to a similar situation regarding the taxpayer in *Roberts*.

It has been argued that the decision in *Kropp* was unique and was decided primarily on the specific facts of the case.⁵⁰ All of the above factors lead to the conclusion that the work in Canada was temporary. Although technically the taxpayer was no longer an employee of the Australian firm, Waddell J found:

it could have been anticipated with considerable confidence that he would be re-employed in Australia at an increased salary and that the rate of increase of salary in his remaining professional life would be accelerated.⁵¹

Policy considerations

Deductibility of self-education expenses affects not only the tax position of a student but can also affect an employer's FBT liability. *Roberts'* case, which technically follows the established cases, has a number of shortcomings. Cooper J failed to consider the comments of Windeyer J in *Finn* regarding employment by separate people, and did not consider a purpose approach to determining deductibility of outgoings. If Cooper J had considered these principles, then it is submitted that a

⁴⁶ Above n 42 at 4407.

⁴⁷ Above n 1 at 4791.

⁴⁸ Above n 42 at 4411.

⁴⁹ Above n 1 at 4790.

⁵⁰ See comments of Ormiston J in *Klan v FCT* 85 ATC 4060 at 4067.

⁵¹ Above n 42 at 4411.

more equitable result would have occurred.

A broader and more liberal approach to deductibility of self-education expenses would encourage higher educational qualifications. As Beyer⁵² points out, government spending on education has now decreased and it is expected that a more onerous user-pays system will be introduced. If the users must pay, one way to induce them to incur self-education expenses, so necessary for the country's development, is to allow them tax deductions or rebates.⁵³

Employers often cannot afford to have employees on leave for one or two years. The only option for many employees, such as the taxpayer in *Roberts*, is to resign from work to complete their study. Current tax law in Australia rules that their expenses would not be deductible. The message sent to all employees contemplating such courses of action is that there is no support available for such risk taking. In a time when our country is being exhorted to become the "clever country",⁵⁴ this is a short-sighted policy.

Perhaps it is time for parliament to re-visit the deductibility of educational expenses. Expenditure for the purposes of self-education should be deductible and free from FBT, provided the objective *purpose* of such education is to ultimately increase the student's assessable income. This position is akin to that in the United States, where deductions are allowed for education expenses which are incurred to "maintain or improve skills required in the taxpayer's trade or business".⁵⁵ Alternatively, provision should be made for such expenditure (and any resulting FBT) to be depreciated over the determined life of such a qualification. Such an alteration to the rules allowing self education deductions may provide the incentive employees and employers need to take the risk now and expend monies on an asset that will benefit the entire community in the long run.

⁵² Above n 5 at 70.

⁵³ Above n 5 at 75.

⁵⁴ Above n 5 at 70.

⁵⁵ Rose & Chommie, *Federal Income Taxation* (3rd ed 1988) 82.