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CONTENTS

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An ordered approach to the tax

In spite of the deficiencies in the legislation, Australia’s core tax rules do have a conceptual structure and considerable coherence even if not immediately apparent. It is submitted that student understanding of this structure and coherence and better problem solving is more likely to be achieved if the author’s approach to problem solving is adopted.[2] Briefly stated, the approach centres on the conceptual structures in the general provisions, and from there, the focus turns to “remedial” provisions that address a “failure” of the conceptual structure.

The article argues that students should adopt the suggested ordering in their tax problem solving, as this is the best way of ensuring comprehensiveness and accuracy in the solution. It is also suggested that the suggested ordering better reflects legislative intent (or the correct interpretation of the legislation). Further, through promotion of comprehensiveness that facilitates awareness of relationships between rules, the suggested approach should make a contribution towards the promotion of “deeper learning”. The author concedes that following a “disordered approach”[3] does not necessarily lead to errors in problem solving as the problem solver may get to the correct outcome in any event.[4] It is submitted though that the author’s ordered approach to the tax rules gives a much higher chance of better problem solving compared to a disordered approach.[5]

Aside from this introduction and the conclusion, the article is in three parts. Part 2 sets out the broad structure or fundamental structure of most of the tax rules studied in a first income tax course. This outline is divided into Receipts, Profits, Gains or Benefits, which activates assessable income or charging provisions (Sub-Part 2.1), and Expenses, Outgoings or Losses, which activates expense conferral provisions (Sub-Part 2.2). Part 3 provides examples of a number of errors that first-time tax students have made in tax problem solving in assignments, tutorial problems, exams, etc, as observed by the author over a considerable period. Some of these “errors” do not necessarily lead to a substantively incorrect answer, although incorrect as a matter of tax law.

[2] It is possible that first time tax students, on the advice of their tax lecturers, may be using a particular approach. Further, in P Burgess, G S Cooper, R E Krever, M Stewart and R J Vann, Cooper, Krever & Vann’s Income Taxation: Commentary and Materials

Part 4 sets out the suggested ordering approach to tax rules in the core areas of study for first time students. Part 4 also explains why the ordered approach is a superior approach to the application of tax rules. At times, this discussion is cross-referenced to the errors in Part 3. The conclusion of the article is that the ordered approach is very likely to lead to better tax problem solving and a deeper understanding of the tax rules.

Proceeds of business (3) Return from property (4) Compensation receipts principle (compensation for lost income or lost revenue asset) and (5) Factorial approach to characterisation (i.e. taking account of all the facts, the amount is income).[12] The negative criteria refer to the presence of a fact or circumstance that denies the receipt being income. The presence of just one negative criterion in regard to a positive criterion (category) is enough to prevent an amount being income under that category.[13]

At the risk of over-simplification, and even inaccuracy, the following table attempts to capture the most relevant criteria (principles):

POSITIVE CRITERIA	NEGATIVE CRITERIA
Proceeds of Personal Exertion: The receipt, gain or benefit is a product of the taxpayer's personal exertion	(a) The receipt is received by the taxpayer as a mere gift; or (b) The receipt is received as a mark of esteem; or (c) The receipt is received in recognition of an achievement; or (d) The receipt is received as a sign of respect for the recipient; or (e) The receipt is for giving up a right that is regarded as a capital or structural right; or (f) The benefit, being a non-cash benefit, cannot be converted into money
Proceeds of Business The receipt, gain or benefit is a product of the taxpayer's business. This should also cover the so-called isolated business venture (or isolated profit-making venture)	(a) The receipt is received by the taxpayer as a mere gift; or (b) The receipt is received as a mark of esteem; or (c) The receipt is received in recognition of an achievement; or (d) The receipt is received as a sign of respect for the recipient; or (e) The receipt is for giving up a right that is regarded as a capital or structural right "of the business"; or

conclusion. Section 15-2 corrects to overcome the non-convertibility doctrine for non-cash benefits.[16] While s 15-25 may be correcting for the capital conclusion, it may also be correcting for the difficulty of linking the receipt to the former lessee's use of the premises. Subsection 20-35(1) (recoupment of expenses for which certain deductions were obtained) may be correcting for the failure of the judiciary to adopt a general reimbursement principle.[17] Subsection 40-285(1) (recoupment of previous depreciation deductions on sale of depreciating asset) is correcting for the fact that tax depreciation (deductions) was faster than economic depreciation. But s 40-285(1) also corrects for the capital conclusion in regard to the sale proceeds above original cost of the asset.

It should be noted that not one specific assessable income section studied in a first income tax course expressly requires the receipt or profit to be capital in nature in order for the specific assessable section to apply.

Some specific assessable income sections do not appear to have any real role because the receipts dealt with in those sections are very likely to be income in any event. Section 15-15 (profit from profit-making undertaking), s 15-20 (ordinary royalty), s 15-30 (insurance or indemnity for lost amount that would have been assessable income), s 15-50 (work in progress receipt) and s 70-115 (insurance or indemnity for lost trading stock) are likely to be in this category.[18]

At least once where the legislature has corrected for a deficiency in the income concept that correction is not by way of a specific assessable income section. The example is s 21A of the *Income Tax Assessment Act 1936*. This section does not include an amount in assessable income. Rather, the main thing s 21A does is to overcome (displace) the non-convertibility doctrine in regard to non-cash benefits obtained by a business taxpayer.[19] That means that the requirements of s 6-5 (or requirements of any other specific assessable income section) still need to be satisfied in order for the value of the non-cash benefit to be included in assessable income.

There is no express ordering rule. That is, there is no express guidance advising the problem solver that the ordinary income section must be applied before a specific assessable income section, or the other way around. However, many specific assessable income provisions coordinate with s 6-5 so that if s 6-5 applies to include the receipt in assessable income, the specific provision will not include the receipt in assessable income (e.g. ss 15-2, 15-10, 15-25). The presence of these express co-

[16] A non-cash benefit that cannot be converted into money is not income: *FCT v Cooke and Sherden* 80 ATC 4140 at 4149. In light of the decision in *Smith v FCT* 87 ATC 4883, and in particular, the judgment of Brennan J at 87 ATC 4888, a strong case can be made that employment (s 15-2) is a broader concept than an income-producing activity (s 6-5), and that therefore s 15-2 has a broader operation than s 6-5.

[17] A general reimbursement principle could involve a rule such that, where a taxpayer obtains a reimbursement or recoupment of an expense that was deductible under the general deduction section, then the reimbursement would be income: *FCT v Rowe* 97 ATC 4317 at 4319. The existence of such a principle was rejected some 45 years ago in *H R Sinclair Pty Ltd v FCT* (1966) 14 ATD 194 at 195 (per Taylor J) and at 196 (per Owen J). And, more recently, the principle was also rejected in *FCT v Rowe* 97 ATC 4317 at 4321 and at 4329.

[18] Given the case law on the predecessor provisions to ss 15-15 (s 25A), 15-30 (s 26(j)) and 70-115 (s 26(j)), it is hard if not impossible to see why the transactions covered by those provisions is not income.

[19] Section 21A also seems to provide a valuation rule for all non-cash business benefits (i.e. whether or not the benefit is in fact convertible into money): see introductory words in s 21A(2).

could otherwise have been an inclusion under a specific assessable income section.[26] As expected, these exempting provisions deal with particular categories of receipts profits and/or circumstances. In a sense, each specific exemption provision is correcting for the "overreach" of the assessable income provision that would otherwise apply.

Sometimes, an exempting provision seems to be in the legislation merely to make absolutely certain that a particular receipt is not to be treated as assessable income (i.e. exempting provision probably not required[27]).

2.1.4 CGT Capital Gains Tax (CGT)

The capital gains tax regime is a significant regime within the income tax in terms of inclusions in assessable income.[28] The CGT regime can include an amount in taxpayers' assessable income if the taxpayer has a "net capital gain".[29] It is important to note that an assessable income inclusion is the only outcome that can arise from the

J 0 02 6]TJ 9.7(-36 Tm (9 Tw CGT regime for a taxpayer 0.0337 Tw 4.25 0)19(t)-o1(t)8(ap3(o)2(ns11(ap)2(i)13e1-224)

where both regimes would otherwise apply to expenditure.[58] Indeed, subject to CGT cost base or CGT cost recognition,[59] s 40-880 is usually last in order of application.[60]

Finally, where an expense satisfies more than one deduction section (i.e. double deduction), s 8-10 provides an express rule to prevent this by requiring the deduction to only be deducible under the most appropriate provision.[61]

2.2.3 Deduction Denial or Loss Disregard Provisions

This category of provisions (or regimes) denies deductions or loss recognition for certain types of expenditures. The implication is that aside from the deduction denial provision, the designated category of expenditure would be deductible or receive loss recognition. And, that recognition would normally occur through the general deduction section.[62] Accordingly, deduction denial provisions can be seen as correcting for the broadness (overreach) of the general deduction section, as interpreted by the judiciary. Some examples of deduction denial provisions are: ss 26-52 and 26-53 (bribes to public officials) and s 26-54 (loss or outgoing in pursuance of a serious illegal activity).

At times, the deduction denial provision is only directed at denying part of a deduction otherwise available. A number of these provisions will usually cap the deduction at a "market value". For example, s 70-20 reduces the deduction to the market value of the trading stock purchased where the taxpayer has paid an inflated price for the trading stock under a non-arm's length transaction. Section 26-35 does a similar thing in regard to excessive payments made to a relative for their services.

Some provisions that look like deduction denial provisions are really only "deduction deferral provisions". Subsection 26-10(1) is in this category (no deductions for annual leave, long service leave, etc, until the amount is paid). Sections 82KZM and 82KZMD of the ITAA 1936 are also in this category (deduction for pre-paid expenditure deferred over the period to which the expense relates).[63]

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[58] Subsection 40-880(5)(b).

[59] There are times where the cost base is not relevant in calculating a gain or loss on a CGT event (e.g. CGT event D1, CGT event F1). In these circumstances though, the taxpayer is permitted to take costs of the event into account in calculating the gain or loss.

[60] Subsection 40-880(5).

[61] There is no guidance on how to determine the most appropriate provision, but thankfully, in many cases, it will not matter because both sections will give the same amount of deduction and give it at the same time. It is also worth mentioning another anti-double cost counting provision, namely, s 82 of the ITAA 1936. This section prevents an expense being taken into account in working out the profit or loss that is assessable income or deductible respectively on a transaction, where the expense is a deduction in its own right.

[62] This is not always the case though. There are some deduction denial provisions that are denying deductions that would otherwise arise outside of the general deduction section (e.g. s 26-55).

[63] The deduction quarantining rules (or tax loss quarantining rules) in ss 26-47(2) and 35-10(2) could also be viewed as deduction deferral rules.

A feature of a number of deduction denial provisions is that many of them only apply to taxpayers that are carrying on a particular income activity (e.g. business, non business).

There are a small number of examples though where a deduction denial provision seems to have a limited role (if any role) because the expenditure does not appear to come within a deduction conferral section in any event.[64] The deduction denial provision is often designed to make absolutely certain that a deduction is not available.

2.2.3.1 Some Deduction Denial Regimes are often complicated by Exceptions to the Deduction Denial

The reason for complication is that while these regimes contain a deduction denial rule, they also contain exceptions to the deduction denial rule. This can make it difficult to characterise the rules, or the role of the rules within these regimes. In spite of the presence of exceptions to the deduction denial rule, these regimes must still be seen as deduction denial regimes, rather than as deduction conferral provisions. The rules (regimes) dealing with: (1) entertainment expenditure[65] and (2) non-compulsory uniforms[66] can be put into this category.

2.2.4 Cost Base of CGT Asset or other Cost Recognition under CGT Regime

The cost base or reduced cost base of a CGT asset is the main source of recognition for expenditure under the CGT regime.[67] This aspect of the CGT regime corrects for the fact that expenditure included in the cost base would not otherwise receive recognition under the general deduction section or under a specific deduction section.

The cost base, which is used when calculating a capital gain, contains five elements, and those elements are exhaustive of what can be included.[68] The first element is the acquisition cost of the asset. For the second element, which deals with incidental costs associated with the purchase and sale of the asset, there is a list of 10 items, and these are exhaustive (i.e. must fit within them otherwise not included).[69] The items listed in

64

3.1.2.1 Sale Proceeds for Depreciating Asset: Example 6

Upon the sale of a depreciating asset, that is, an asset that has attracted decline in value deductions under s 40-25, students often commence (and complete) their analysis of the sale transaction at s 40-285. This section requires a comparison of the "termination value" and the "adjustable value" to determine if an assessable income gain inclusion is made, or a deductible loss is made. The termination value of the asset does not include an amount included in assessable income under s 6-5.[81]

While not common, s 6-5 will apply where the asset is a revenue asset and the asset is sold for an amount above its cost of purchase.[82] Where this is the case, the answer obtained solely under s 40-285 will not be correct because the amount above original cost will be included in assessable income under s 6-5. The overall answer though in terms of the assessable income inclusion will be correct.[83] A related error, sometimes made, is that students' claim that the sale proceeds for a depreciating asset are on

the cost base exclusion rule for deductible expenditure. This will be the case at least in regard to the borrowing expenses. They are deductible under s 25-25. And there is no analysis as to why s 8-1 does not apply to any of the expenses, which may have meant that the borrowing expenses also satisfied s 8-1. Further, there was no analysis as to why each expense was capital. And, in any event, there is no requirement that expenditure must be of a capital nature for it to be included in the second element of the cost base.[94]

3.2.1.4 Travel Expenses from Home to a Workplace: Example 13

Where a taxpayer, who is “on call” like the taxpayer in FCT v Collings[95] (i.e. work begins at the time the taxpayer receives a phone call at home from their employer), travels “to” work, an analysis that states that the taxpayer is denied a deduction for the travel costs because of s 25-100(3) is incorrect. Subsection 25-100(3) states that travel between 2 places is not “travel between workplaces” if one of the places you are travelling between is a place at which you reside (home).

The error here is that s 25-100(3) is only relevant to s 25-100; indeed, the only thing s 25-100(3) does is provide an exception to the “travel between workplaces” concept. The taxpayer in FCT v Collings is obtaining her deduction under s 8-1, not s 25-100. Section 25-100 remains irrelevant to the operation of s 8-1.[96] The other error that this reasoning reveals is that a specific deduction conferral section is being viewed as a deduction-denial section.

3.2.2 Analysis Commences at a Deduction Denial Regime (Example 14)

This is also a common mistake. Similar to the above category of errors, this error is largely based on the idea that the problem solver is “attracted” to the deduction denial regime because the expenditure fits the description in that regime. Only one example is provided.[97]

3.2.2.1 Entertainment Expenditure: Example 14

The suggestion is often made that s 32-45 provides a taxpayer with a deduction for entertainment expenses (e.g. providing *entertainment to promote or advertise to the public a *business or its goods). This analysis is incorrect. Section 32-45 does not confer a deduction; it is not a specific deduction conferral section. Section 32-45, in combination with s 32-5, merely “restores” a deduction that has been denied by operation of s 32-5. Section 32-5 contains the deduction denial rule. The relevant part *entertainment, you cannot deduct it under section 8-1." The words: "Section 32-5 does not stop you deducting…" in s 32-25 is the authority for this. Restoring a deduction is the only role of s 32-45 (in combination with s 32-5). Therefore, the conferral of a deduction for entertainment expenditure must come from the general deduction section (s 8-1) there being no other section conferring a deduction for such expenditure. This is also the clear implication from s 32-5.

One question is, does this incorrect reasoning lead to an incorrect answer on the deductibility question? The answer is probably not, but this would be through "good luck", rather than sound tax problem solving. The key point is that when one examines the three circumstances in s 32-45, all of those situations described would seem to satisfy the general deduction section.[98] Let me repeat though, our problem solver has not applied s 8-1, the only possible deduction conferral section, to the relevant expenditure. The problem solver will not end up at the correct conclusion where the described circumstances do not satisfy s 8-1.

The point made about s 32-45 can equally be made about ss 32-30 to 32-40 and s 32-50, other provisions within the entertainment deduction denial regi

3.2.3.3 Capital Allowance Regimes not considered where Capital Repair Expenditure involved: Example 17

the central concepts/criteria (both positive and negative) are adopted or corrected for in specific assessable income sections and the CGT regime. The main deficiency (or deficiencies) not corrected for are the mere gift and personal recognition situations (i.e. not taxed). In short, it is suggested that it is more likely that better quality problem solving will take place under the specific assessable income sections where the problem solver brings the "full picture" from s 6-5 to the specific assessable income section (Step 2), and for that matter, Steps 3 and 4.[106] The idea is that where the problem solver has formed a view about the taxpayer's activity or transaction under general principles (s 6-5), it is harder for that problem solver to erase or contradict that view when undertaking the required analysis under a specific assessable income section. One needs to bear in mind that specific assessable income sections can provide new "distractions" for the problem solver.

For example, take a taxpayer that owns a rental property and who is deriving passive property income (not income from a business). The taxpayer receives a subsidy to assist with extending a building on the property. It is likely that the subsidy will be capital under s 6-5. If the problem solver also observes or notes when undertaking the s 6-5 analysis that the taxpayer's rental property activity is not a business, the problem solver is likely to bring that non-business conclusion into the s 15-10 analysis and

In Example 8 (sale of main residence), the problem solver has failed to apply the

FBT income tax). This means that the approach to the tax rules set out in Sub-Part 4.2.1 above applies.

4.3 Order of Approach to Tax Rules when dealing with Expenses, Outgoings or Losses

4.3.1 Ordered Approach

The following steps are the suggested order of application of the tax rules when dealing with expenses or outgoings. Note also the ordered approach within each regime/section within each step:

1. The general deduction section (s 8-1);
2. Specific deduction conferral sections, or sections that provide a deduction (e.g. s 25-5, 25-25, 25-100, 30-15, 40-25, and 40-880), aside from the cost base of a capital gains tax asset;
3. Deduction denial sections, or sections that withdraw a deduction (or defer a deduction otherwise available in the current income year), that would otherwise satisfy a deduction conferral section (e.g. ss 26-20 and 26-35); and
4. The cost base of a capital gains tax asset.

Importantly, where the problem-solving forum for the course permits (e.g. tutorial; seminar; to a lesser extent, written assignments), it is suggested that all of the above steps are engaged in, even where s 8-1 applies (Step 1) to confer a deduction.

In regard to Step 1, the analysis ought to be comprehensive in the sense that the key positive criteria and the key negative criteria in s 8-1 are considered in turn. The reason is that the specific deduction conferral provisions, deduction denial provisions and the CGT cost base regime correct for deficiencies in the general deduction section (i.e. to narrow or to broad) so that many of the central concepts/criteria (both positive and negative) are adopted or corrected for in specific deduction conferral provisions, deduction denial provisions and CGT cost base provisions. In other words, it is submitted that it is best to have the full picture when completing the s 8-1 analysis and embarking on the analysis in Steps 2 to 4. Again, like the suggestion for receipts, the idea is that where the problem solver has formed a view about the taxpayer's activity under general principles in s 8-1, it is harder for that problem solver to erase or contradict that view when undertaking the analysis under a specific deduction section or CGT cost base rules. And, the key structures in s 8-1 do often form an important part of specific deduction sections and CGT cost base rules (e.g. relevance of expense to income production, capital character of expense, apportionment of expense).[114]

For example, take a taxpayer that incurs expenditure in opposing the grant of a licence to a new entrant into the taxpayer's business sector.[115] The expenditure is capital. If the problem solver also observes or notes when undertaking the s 8-1 analysis that the

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[114] Given that the depreciating asset regime appears to be an exclusive code in regard to deductions on disposal of a depreciating asset (Australia and New Zealand Banking Group Ltd v FCT 93 ATC 4238 at 4277-4278), in effect, the Step 1 analysis in this article is bypassed. That is, no deduction is available under s 8-1 where the depreciating asset is sold for less than its cost of purchase.

[115] These were the facts in Broken Hill Theatres Pty Ltd v FCT (1952) 9 ATD 423.

expenditure is sufficiently relevant to the taxpayer's business, the problem solver is likely to bring that relevance conclusion into the s 40-880 analysis and therefore, in all probability, avoid the error of concluding that s 40-880 cannot apply because the expenditure is not related to the business. The problem solver who merely concludes that s 8-1 does not apply because the expenditure is capital will be starting the s 40-880 analysis from scratch. This will not necessarily lead to an error because the problem solver may simply undertake a comprehensive analysis of the s 40-880 business/non-business dichotomy.

A similar approach ought to be taken in regard to Step 2. Many specific deduction conferral sections have a positive requirement(s) and a negative requirement(s). Like the approach to the positive and negative criteria within the general deduction section, it is suggested that the positive and negative requirements of specific deduction conferral sections are analysed in turn.

A systematic approach ought to be taken in regard to Step 3 (deduction denial provisions). Some deduction denial sections or regimes solely contain a deduction denial rule. However, some contain a deduction denial rule but also exceptions to that deduction denial rule. It is suggested that for these regimes, you should start your analysis at the deduction denial rule, and only after that, should your analysis move to the exceptions to the deduction denial rule.

A systematic approach should also be taken in regard to Step 4. That is, the focus should first be on the positive elements of the cost base of a CGT asset that include an expense in the cost base or reduced cost base. From there, the analysis should move to the negative criteria whereby expenses are excluded from the cost base.

4.3.2 Justification for Ordered Approach

The central justification for the suggested approach is essentially the same as that given for receipts above; that is, it is more likely to lead to a correct answer to a tax problem mainly because the approach encompasses a comprehensive analysis to the problem whereby all provisions or regimes or rules within regimes that can govern the tax outcome of the transaction are considered. Indeed, an ordered approach is a higher priority in regard to expenses compared to receipts because of the fewer "mechanisms" built into the expense rules that correct for poor problem solving.

Again, the ordered approach suggested here does not guarantee a correct answer to a tax problem because the problem solver still has to identify the relevant rules, determine the scope of those rules and deal with characterisation issues within those rules. The ordered approach does not assist and is not intended to assist in this regard. Further, the ordered approach will not necessarily be superior to other approaches for all problem solvers because the problem solver using another approach may end up with the required coverage of relevant provisions in any event. For example, a problem solver might commence at the CGT provisions first and conclude that interest expenditure to purchase a rental property does come within the third element of the cost base. Then, he or she "may" work through s 110-45(1B) and note that the expenditure is excluded from the cost base if it is deductible (anti-double counting rule), which may have the effect of pointing the problem solver back to s 8-1

would have been developed under the general deduction section, in the absence of a repair section.[121]

In addition, because of the type of expenditure involved, a narrower range of specific deduction conferral sections will be relevant at Step 2. The suggested order therefore is:

1. The repair section (s 25-10);
2. Deduction conferral sections, or sections that provide a deduction (e.g. s 40-25, s 43-10), aside from the cost base of a capital gains tax asset;
3. Deduction denial sections, or sections that withdraw a deduction; and
4. The cost base of a capital gains tax asset.

The error in Example 17 (i.e. no thought given to including expenditure in the "cost base" recognition rules under Division 40 or Division 43 once the expenditure has been found to be a "capital repair") is far less likely to be made had the suggested order been followed.

5. CONCLUSION

The tax rules studied in a first income tax course suffer from a number of deficiencies including overlap in assessable income provisions, overlap in deduction or cost recognition provisions, a general lack of express ordering rules and the presence of regime co-ordination rules that are hidden. In spite of this, the core tax rules do have a conceptual structure and considerable coherence. There is a real need therefore for a problem solving approach that reveals the conceptual structure of and the coherence within the tax rules so that deficiencies in the legislation do not undermine good problem solving.

With the aim of revealing the conceptual structure of the main tax rules, coherence of the rules and the interaction between the main tax rules, this article did set out the nature of the main tax rules (Part 2). From there, the article gave a number of examples of defective problem solving from disordered approaches to the application of the main tax rules to given facts (Part 3). These disordered approaches took no account of the conceptual structure and the coherence embedded within the main tax rules. Part 4 then introduced the author's ordered approach to the application of the tax rules to problem situations. Largely against the background of the facts in the examples in Part 3, it was demonstrated that the author's ordered approach is likely to consistently lead to better problem solving compared to disordered approaches. The reasons for this is that the author's ordered approach takes account of the conceptual structure of the tax rules and the coherence within those rules, and it is the only approach that has comprehensiveness as a main element of the problem solving process.

[121] The discussion of the relevant principles in repair cases: FCT v Western Suburbs Cinemas Ltd (

5.4 Paradigm/Model CGT Framework: Essential Elements of First Charging Provision of the Capital Gains Tax
5.5 Assets, Exempt Assets and Asset Classification
5.6 Acquisition and Disposal (CGT Events)
5.7 Timing Issues
5.8 Calculating Gain or Loss
5.9 Second Charging Provisions of the CGT Regime
5.10 Determining Taxable Gain and Integration with Non-CGT Provisions

SEMINAR SIX

6.1 Overview of Expense Recognition under the Income Tax Assessment Acts
6.2 Deductions: General Principles
6.3 Relevant Expenditure: Test(s) of Deductibility
6.4 Expense Apportionment

SEMINAR SEVEN

7.1 Personal/Non-Personal Boundary Expenditure

SEMINAR EIGHT

8.1 Contemporaneity Principle
8.2 Revenue/Capital Boundary
8.3 Capital Allowance Regimes

SEMINAR NINE

9.1 Other Deduction Conferral Provisions
9.2 Deduction Denial Provisions
9.3 Tax Accounting: An Overview
9.4 Tax Accounting for Trading Stock

SEMINAR TEN

10.1 Taxable Income obtained through "Entities": An Overview
10.2 Taxation of Taxable Income obtained through a Partnership: An Overview
10.3 Existence of a Partnership
10.4 Taxation of Partnership's Taxable Income/Tax Loss
10.5 Transactions between Partners, Transactions between Partners and "The Partnership" and Transactions between Partnership and Third Parties
10.6 Taxation of Taxable Income obtained through a Trust Estate: An Overview
10.7 Existence of a Trust Estate/Trust
10.8 Taxation of Trust Estate's Taxable Income

SEMINAR ELEVEN

11.1 Taxation of Taxable Income obtained through a Company: An Overview
11.2 Existence of a Company
11.3 Classification of Companies for ITAA Purposes: Private or Public
11.4 Calculation of Companies' Taxable Income or Tax Loss, and Tax Payable by Companies
11.5 Imputation System: Company's Perspective

11.6