# NEGATIVE GEARING : FLETCHER'S CASE

by

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## (A) INTRODUCTION

An investment is said to be negatively geared where the income derived from the investment is exceeded by the interest cost of borrowing and other on-going costs of the investment. The most common example of negative gearing is the purchase, wholly or partly by debt, of a rental property by an investor. The scheme is designed so that loan repayments (usually on an interest-only loan) exceed the rental income. The resulting loss is claimed by the taxpayer as a deduction against other assessable income. In this way the taxpayer reduces his or her tax liability and stands to make a capital gain on sale of the property. Provided the after-tax capital gain exceeds the accumulated after-tax losses, the taxpayer has used debt to become better off.

The scope of negative gearing was explained by Lockhart J in *FCT v Total Holdings (Aust.) Pty Ltd*:

> '...if a taxpayer incurs a recurrent liability for interest *for the purpose of furthering his present or prospective income producing activities*, whether those activities are properly characterised as a business or not, generally the payment by him of that interest will be an allowable deduction.'[1] (Emphasis added)

During the 1985/1986 and 1986/1987 tax years the government restricted the availability of negative gearing by limiting the deduction for interest costs on money borrowed to purchase rental property to the net rental income.[2] Intense lobbying from the property sector prompted the government to remove this restriction in the 1987 Federal Budget.[3] This, combined with the subsequent Stock Market Crash, heralded the 1988 property market boom. Investors flooded into the property market buoyed by the security and tax effectiveness of their investment. Consequently, any move to limit the current scope of negative gearing must be the subject of concern and further evaluation.

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1 *FCT v Total Holdings (Aust.) Pty Ltd* 79 ATC 4279 at 4283 per Lockhart J.

2 *Income Tax Assessment Act* ss 82KZC-82KZK.

3 s 82KZD(1A). This provision has the effect of rendering s 82KZD, the provision which created the limitation on deductions for rental property loan interest, inoperative for the 1987/1988 and subsequent income years.

## (B) FLETCHER'S CASE

Some have identified the recent Full High Court decision in *Fletcher & Ors v FCT*[4] as one such move.[5] The purpose of this article is to evaluate whether the fears raised by the case are justified. In so doing, one must establish whether the High Court has crossed the bounds of established authority or has merely applied existing authority to the facts before it.

*Fletcher* involved an arrangement far removed from that of the 'ordinary' negatively geared property investor. The taxpayers, partners in a property development business, borrowed money to fund the purchase of an annuity and sought a deduction for the interest payable on the borrowings. What focused the Commissioner's attention on the scheme were the projected income flows from the annuity during its purported 15 year life. As income flows for the first five years were low, the substantial interest costs gave rise to large losses. Increased income flows and correspondingly smaller losses characterised the second quinquennium. For years 11 to 15, the projected income from the annuity would increase to an extent which would see large net gains accrue to the taxpayer.

The very nature of the scheme must distinguish its taxation status from that of the 'ordinary' negatively geared property investor. In fact, Richards comments

> '...at first glance, it looked as if it involved nothing more than a very obvious tax avoidance scheme.'[6]

However, the potential scope of the decision can only be ascertained through an analysis of the statements of principle present in the judgment. The Court pronounced three legal principles which assume relevance to negatively geared property investor.

### (1) The concept of purpose is relevant as a determinant of deductibility.

The Court proceeded to distinguish between the objective purpose of the expenditure and the taxpayer's subjective purpose in incurring the expense.

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4 *Fletcher & Ors v FCT* 91 ATC 4950.

5 See for example Tomlinson, 'Fresh doubts on negative gearing value', *The Weekend Australian*, January 25-26 1992, p 44.

6 Richards, 'Fletcher's Case: An Epic Battle', *Australian Accountant*, February 1992, p. 72.

## (a) Objective Purpose

> '...it is commonly possible to characterise an outgoing as being wholly of the kind referred to in the first limb of s 51(1) without any need to refer to the taxpayer's subjective thought processes. That is ordinarily so in a case *where the outgoing gives rise to the receipt of a larger amount of assessable income.*'[7] (Emphasis added)

Therefore, where assessable income from an investment exceeds the costs of that investment, this *in itself* suffices to characterise the expense as one incurred in gaining or producing assessable income.[8] The relationship between the expense and the income derived from that expense clearly satisfies the nexus required by the first limb of s 51(1). The Court applied this principle to the facts before it:

> 'If the assessable income actually derived under the annuity agreement in each of the tax years had been at least equal to the actual outgoings of interest, there would, in the absence of any other deductible expenses, have been little difficulty in characterising those outgoings as wholly incurred in gaining or producing that assessable income. In fact, however, the assessable income derived from the annuity in each of the tax years was less than one-eighth of the adjusted outgoings of interest in that year.'[9]

By definition, a negative gearing arrangement operates outside the above principle. The thrust of the High Court's reasoning is that objective purpose does not have a role where an investment is negatively geared. The Court is arguing that the link between expense and income is not objectively apparent from a negative geared transaction. This argument is no doubt based on commercial reality: the incurring of loss from an investment *prima facie* does not make business sense. The objectively apparent loss may provide evidence that the purpose of the arrangement is not to produce income, but to serve some motive unconnected with the production of income. The conduct of a negative geared investment must therefore be explained by the *actual motive* of the taxpayer.

The corollary of the High Court's argument is simple: where on the link between expense and income is apparent on the face of the transaction there is no need to analyse the taxpayer's subjective purpose in incurring the expense. The example provided by the Court, where the income derived from an investment exceed the costs of that investment, is merely the most basic illustration of the situation where the above nexus is *prima facie* apparent. *This does not serve to deny the role of the objective purpose in other circumstances where there is a clear connection between the expense and assessable income.*

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7 *Fletcher & Ors v FCT* 91 ATC 4950 at 4957-4958.

8 *Fletcher & Ors v FCT* 91 ATC 4950 at 4958.

9 *Fletcher & Ors v FCT* 91 ATC 4950 at 4958.

## (b) Subjective Purpose

Where the costs of investment exceed the income derived from that investment, the essence of negative gearing, the taxpayer's subjective purpose or motive is a determinant of the deductibility issue.

> '...the disproportion between the detriment of the outgoing and the benefit of the income may give rise to the need to resolve the problem of characterisation of the outgoing...by a weighing of the various aspects of the whole set of circumstances, including the direct and the indirect objects and advantages which the taxpayer sought in making the outgoing.'[10]

If, upon considering the taxpayer's subjective purpose(s), the court can properly conclude that the whole outgoing was genuinely incurred in gaining or producing assessable income, the first limb of s 51(1) is satisfied.[11]

The negatively geared investor must therefore be in a position to substantiate a link between the expenditure and assessable income.

## (2) The negatively geared investment must be aimed at producing assessable income.

An investment designed to incur losses in perpetuity does not afford credence to the explanation that the investment was entered into for income-producing purposes.

The Court noted that the substantial projected cash surplus accruing to the taxpayers in the final quinquennium of the annuity would give rise to a proportionately substantial tax liability. Because the annuity agreements provided the taxpayers with the option of 'avoiding' the last five years of the 'plan', thereby avoiding this tax liability, the Court doubted whether the agreements would run their full course.

If the arrangements were fully performed, the total assessable income accruing to the partnership would exceed adjusted outgoings by some $1.7m. Were this situation to eventuate

> '...the adjusted outgoings of interest payable under the two loan agreements would properly be characterised as *incurred in gaining or producing the totality of the assessable income* payable under the annuity agreement over its purported 15-year term.'[12] (Emphasis added)

The *eventual* excess of assessable income over expense would serve to satisfy the s 51(1) nexus. In the case of negatively geared property investors, the nexus may be satisfied by the hope that the capital gain on disposal will exceed the losses incurred.

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10 *Fletcher & Ors v FCT* 91 ATC 4950 at 4958.

11 *Fletcher & Ors v FCT* 91 ATC 4950 at 4958.

12 *Fletcher & Ors v FCT* 91 ATC 4950 at 4960.

If the reality of the situation predicated that the arrangements would be effectively terminated within the first ten years of the plan

> '...the excess of the adjusted outgoings of interest over assessable income in each of the tax years could not be explained by reference to surplus assessable income which was expected to be derived in subsequent years. To the contrary, it would be necessary to *look for some other explanation* of the planned expenditure of outgoings of interest which exceeded assessable income by more than $2.7m in the first 10 years of the scheme.'[13] (Emphasis added)

That 'other explanation' was apparent to the Court: 'the very substantial personal income tax advantages which the taxpayers were expected to derive from the early years of the 'plan'.'[14] Given that apportionment is required where there exist

> '...undivided items of expenditure in respect of things or services of which distinct and severable parts are devoted to gaining or producing assessable income and parts to some other cause'[15]

the Court considered that apportionment was necessary were the plan not to run its full course. The upshot is that apportionment of deductions is appropriate where the taxpayer's subjective purpose in entering the negative gearing arrangement is not motivated by the gaining of assessable income.

## (3) Where the taxpayer's subjective purpose in entering the negative gearing arrangement is not motivated by the gaining of assessable income, the court may limit the available deduction to the assessable income derived from the investment.

If the scheme were to be prematurely terminated, the High Court considered that:

> '[T]o the extent that the surplus of partnership outgoings of interest over annuity were to be [explained by the objective of securing tax advantages], the outgoings could not properly be characterised, for the purposes of s 51(1), as incurred in gaining or producing assessable income or as not being 'of a capital, private or domestic nature'.'[16]

In so ruling the Court was merely applying the objective purpose principle discussed above. So far as the outgoings did not exceed the income derived from the investment, one could objectively conclude that the s 51(1) nexus between income and expense was satisfied. However, if the subjective purpose of the taxpayer in incurring a loss was not to secure future assessable income, but rather to attain tax advantages, the outgoings exceeding the

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13 *Fletcher & Ors v FCT* 91 ATC 4950 at 4960.

14 *Fletcher & Ors v FCT* 91 ATC 4950 at 4960-4961.

15 *Ronpibon Tin NL v FCT* (1949) 78 CLR 47 at 59.

16 *Fletcher & Ors v FCT* 91 ATC 4950 at 4961.

income could not be characterised as having been incurred for the production of assessable income.

The court will therefore apportion the deduction where it finds that the subjective purpose of the negatively geared investor in respect of the loss arising from the investment has no connection with the production of assessable income.

Apart from the above principles the High Court in *Fletcher* did not make the crucial finding of fact concerning whether the annuity agreement was intended to run its course or be terminated prior to the commencement of the eleventh year. This task was remitted to the Administrative Appeals Tribunal.

## (C) IS FLETCHER FOUNDED ON PREVIOUS AUTHORITY?

In light of the foregoing analysis, it is pertinent to evaluate whether and to what extent the principles espoused by the High Court in *Fletcher* correlate with existing case law. Each of the three principles will be discussed with reference to relevant authority.

### (1) Is purpose relevant to the s 51(1) deductibility issue?

The relevance of purpose to whether an expense is incurred in gaining or producing assessable income has been judicially recognised for some time. In *Deane v FCT; Croker v FCT*[17] Rogers J noted that purpose may be relevant in determining the applicability of the first limb of s 51(1).[18] In *FCT v Ilbery*[19] Toohey J considered that

> '...purpose may *stamp the outgoing as one having no relevant connection* with the gaining or producing of assessable income.'[20] (Emphasis added)

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17 *Deane v FCT; Croker v FCT* 82 ATC 4112 at 4119 per Rogers J.

18 Rogers J quoted *Magna Alloys & Research Pty Ltd v FCT* 80 ATC 4542 at 4547 per Brennan J as authority for this proposition. The relevant portion of Brennan J's judgment reads:

'in cases where a connection between an outgoing and the taxpayer's undertaking or business is affected by the voluntary act of the taxpayer, the purpose of incurring that expenditure may constitute an element of its essential character, stamping it as expenditure of a business or income-earning kind.'

19 *FCT v Ilbery* 81 ATC 4661.

20 *FCT v Ilbery* 81 ATC 4661 at 4667 per Toohey J.

Similarly, the High Court in *Handley v FCT*[21] was of the opinion that:

> '...the ***purpose*** for which the advantage occasioning the loss or outgoing is sought may ***evidence a sufficient relationship*** with the income-earning process...'[22] (Emphasis added)

GN Williams J was more emphatic in *FCT v Kowal*:

> 'It is now clear that the ***purpose*** for which moneys are expended is of ***vital importance*** in determining whether or not the outgoing is incurred in gaining or producing assessable income.'[23] (Emphasis added)

These judicial statements lend weight to the argument that the deductibility of an expenditure is clearly related to its purpose. The courts have further distinguished between objective and subjective purposes:

> 'Purpose may be either a ***subjective purpose*** - the taxpayer's purpose - where it means the object which the taxpayer intends to achieve by incurring the expenditure; ***or*** it may be an ***objective purpose***, meaning the object which the incurring of the expenditure is apt to achieve....An objective purpose is attributed to a transaction by reference to all the known circumstances; whereas subjective purpose and motive, being states of mind, are susceptible of proof not by inference alone but also by direct evidence, for a state of mind may be proved by the testimony of him whose state of mind is relevant to the fact in issue.'[24] (Emphasis added)

This very distinction presupposes that there must be circumstances in which the objective purpose of the expenditure determines deductibility and other (different) circumstances where deductibility is characterised by the subjective purpose of the taxpayer.

## (a) In which circumstances is the objective purpose of the expenditure the determinant of deductibility?

The authorities confirm that the presence of a clear connection between the expense and assessable income is sufficient to characterise the expense as deductible, *without* further reference to the taxpayer's subjective purpose in incurring the expense.

Consider the case of *Magna Alloys & Research Pty Ltd v FCT*.[25] The taxpayer claimed deductions totalling $285,762 in three consecutive years for legal expenses incurred in defending charges brought against its

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21 *Handley v FCT* 81 ATC 4165.

22 *Handley v FCT* 81 ATC 4165 at 4168-4169 per Stephen J. See also *John v FCT* 89 ATC 4101 at 4105 per the Full High Court.

23 *FCT v Kowal* 84 ATC 4001 at 4005 per GN Williams J. His Honour quoted *Ure v FCT* 81 ATC 4100 as authority for this proposition.

24 *Magna Alloys & Research Pty Ltd v FCT* 80 ATC 4542 at 4544 per Brennan J.

25 *Magna Alloys & Research Pty Ltd v FCT* 80 ATC 4542.

directors and agents, concerning criminal conspiracy, arising from claims that these persons induced Government employees to purchase the taxpayer's products in return for gifts for the employees' personal use. The Full Federal Court held that the expenses in question were peripheral and incidental to the carrying on of the taxpayer's business, notwithstanding that the purpose of defending the directors, and not the business purpose, was the principal reason for the expenditure.

In the course of his judgment Brennan J noted:

> '...it is objectively certain that the relevant expenditure was incurred to defray the legal costs of the directors and agents in the criminal proceedings brought against them. The connection between the legal services thus acquired and the taxpayer's business neither requires nor permits reference to the taxpayer's state of mind. *The nature of that connection is to be found in the objective facts...*'[26] (Emphasis added)

Although this statement is aimed at the second limb of s 51(1), it is submitted that Brennan J also intended it to apply to the first limb. This is apparent from His Honour's dicta in the paragraph prior to that quoted above:

> 'The relationship between what the expenditure is for and the taxpayer's [income-earning] undertaking or business determines objectively the purpose of the expenditure.'[27]

*Ure v FCT*[28] provides further evidence of the relevance of objective purpose to deductibility. In their judgment Deane and Sheppard JJ provided the following illustrations:

> 'In the ordinary case where the income which is expected to flow from an outgoing offers an obvious commercial explanation for incurring it the relevant characterisation can readily be determined by reference to the gaining or producing of that income.'[29] (Emphasis added)

> 'In the ordinary sense, such as, for example, where the immediate object achieved by the outgoing is the production of assessable income which is commensurate with the amount of the outgoing...indirect objects or motives of a personal or domestic character will plainly not prevent the characterisation of the outgoing as having been incurred in earning assessable income.'[30] (Emphasis added)

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26 *Magna Alloys & Research Pty Ltd v FCT* 80 ATC 4542 at 4552 per Brennan J.

27 *Magna Alloys & Research Pty Ltd v FCT* 80 ATC 4542 at 4551 per Brennan J. This submission appears to be supported in *Deane v FCT; Croker v FCT* 82 ATC 4112 at 4119 per Rogers J.

28 *Ure v FCT* 81 ATC 4100.

29 *Ure v FCT* 81 ATC 4100 at 4109 per Deane and Sheppard JJ.

30 *Ure v FCT* 81 ATC 4100 at 4110 per Deane and Sheppard JJ. In this context see also *Magna Alloys & Research Pty Ltd v FCT* 80 ATC 4542 at 4559 per Deane and Fisher JJ.

In their statements, their Honours recognised that the subjective purpose of the taxpayer is irrelevant where a clear connection between expense and income is apparent on the face of the transaction. This represents the essence of the High Court's reasoning in *Fletcher.*

## (b) In which circumstances is the subjective purpose of the expenditure the determinant of deductibility?

The authorities support the contention that the subjective purpose or motive of the taxpayer in incurring an expense is relevant where there the link between expense and income is not *prima facie* apparent. Negative gearing was presented as an example of such a situation in *Fletcher.*

*Ure v FCT*[31] is a good illustration of the judicial approach. Ure borrowed money at commercial rates of interest (up to 12.5% p.a) and onlent the moneys to his wife and to the family company (which the taxpayer and his wife controlled) at an interest charge of 1% p.a. The taxpayer claimed a deduction for the entire interest due under the original loan, arguing that the onlending of the moneys was for the purpose of gaining assessable income (namely, the 1% interest charge). The Federal Court did not accept the taxpayer's argument.

Deane and Sheppard JJ considered that where there appears no commercial explanation for incurring an expense

> '...the problem of characterisation must be derived from a weighing of the many aspects of the whole set of circumstances including direct and indirect objects and advantages which *the taxpayer* sought in making the outgoing.'[32] (Emphasis added)

In light of the excess of outgoings over income the Court proceeded to evaluate the taxpayer's subjective purpose(s) in incurring the outgoings. In so doing it concluded that:

> '...it would be a misleading half-truth to say that the object which the taxpayer had in mind or the advantage which he sought in incurring the liability to pay interest at rates of 7.5% or more was the derivation by him of interest at the rate of 1% per annum by re-lending the money which he borrowed....The predominant, though indirect, objects were not concerned with earning assessable income for the taxpayer...'[33]

The issue of *commerciality* highlighted by the Federal Court mirrors the underlying assumption the High Court in *Fletcher* discussed earlier. A transaction which, on its face, results in a loss does not make commercial sense. For this reason, the court must view such transactions with suspicion, a suspicion which will be either confirmed or denied by its analysis of the relationship between the taxpayer's purpose in incurring the expense and expected assessable income.

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31 *Ure v FCT* 81 ATC 4100.

32 *Ure v FCT* 81 ATC 4100 at 4109 per Deane and Sheppard JJ.

33 *Ure v FCT* 81 ATC 4100 at 4110 per Deane and Sheppard JJ.

Therefore, where the court identifies the taxpayer's subjective purpose as the generation of tax advantages,[34] this precludes the conclusion that the expense was incurred for the production of assessable income.

The importance of the commerciality of a transaction was emphasised by the Full Federal Court in *FCT v Janmor Nominees Pty Ltd.*[35] In this case a surgeon caused his family trust to borrow funds to acquire property to be let to him at a commercial rental. The corporate trustee claimed a deduction for the interest payable on the loan ($14,200) which exceeded the rental income paid to the trust by the surgeon ($6,915).

In the leading judgment Lockhart J noted that:

> The more *commercial* the flavour of the leases and rent payable thereunder then the more successful would be [the taxpayer's] application for deductions in respect of the lease payments for the room used as an office.'[36] (Emphasis added)

The commercial flavour of the arrangement led the Court to conclude that the s 51(1) nexus had been satisfied. Lockhart J did not, however, frame his decision in terms of objective and subjective purpose(s). It could be inferred that His Honour's thorough analysis of the transaction evidences a search for the taxpayer's subjective purpose in incurring the interest expense.[37] This contention is inconclusive, especially in view of the following dicta of Fisher J:

> 'Considered *objectively*, the rent has all the hallmarks of assessable income in the hands of the taxpayer trustee and the latter's payments of interest arose out of a commercial arm's length transaction.'[38] (Emphasis added)

Fisher J applied an objective purpose test in circumstances which the High Court in *Fletcher* identified a subjective test as applicable. To this extent, one must doubt the correctness of Fisher J's approach. Further such doubt arises from His Honour's subsequent statement:

> '...motive or subjective purpose is usually nothing to the point in sec 51 situations (*Magna Alloys & Research Pty Ltd v FCT* 80 ATC 4542 per Brennan J at 4551-4552).'[39]

As is evident from the preceding discussion, this statement is clearly incorrect. The thrust of Brennan J's judgment in *Magna Alloys* was that the taxpayer's subjective purpose was not relevant to the facts before him, given

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34 See *FCT v Ilbery* 81 ATC 4661 at 4668-4669 per Toohey J; *Deane v FCT; Croker v FCT* 82 ATC 4112 at 4120 per Rogers J.

35 *FCT v Janmor Nominees Pty Ltd* 87 ATC 4813.

36 *FCT v Janmor Nominees Pty Ltd* 87 ATC 4813 at 4820 per Lockhart J.

37 *FCT v Janmor Nominees Pty Ltd* 87 ATC 4813 at 4820-4821 per Lockhart J.

38 *FCT v Janmor Nominees Pty Ltd* 87 ATC 4813 at 4815 per Fisher J.

39 *FCT v Janmor Nominees Pty Ltd* 87 ATC 4813 at 4815 per Fisher J.

the clear connection between the expense and the taxpayer's business. Brennan J did not lay down a rule that subjective purpose is never relevant to s 51(1).

## (2) Must the negatively geared investment be aimed at producing assessable income?

Although the approach of the Court in *Janmor Nominees* can be questioned, the conclusion is correct. This is because

> '[T]he outgoing of interest was wholly directed to the acquisition of the property as an income earning asset.'[40]

It appears on the facts that the taxpayer eventually *aimed to make a net profit* from the investment, albeit at some time in the future.[41] This would serve to strengthen the alleged link between expense and income.

A deduction will be allowed where there is clear evidence that the negatively geared investment has the potential to become self-supporting. Consider *FCT v Kowal*[42] in which the taxpayer negatively geared a property in which his mother resided. Although the rent charged to the mother was well below market rental, the Supreme Court of Queensland concluded that

> '...looked at over a period of some years, it is clear that the respondent *intended to obtain and in fact obtained a net profit* from the renting of the premises.'[43] (Emphasis added)

The Court was influenced by the formality of the rental agreement, the periodical rent increases and a large capital repayment made by the taxpayer.

That the investment does not have the potential to become self-supporting will not, however, be an automatic bar to deductibility. In this context, consider the following dicta of Deane and Sheppard JJ in *Ure*:

> '...the liability to pay interest may plainly have been wholly incurred in earning assessable income where it is expected or hoped that the re-lending will also lead to assessable income *in another form* being derived or preserved...'[44] (Emphasis added)

Therefore, from the point of view of the negatively geared investor, the fact that future income may assume the form of a capital gain does not

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40 *FCT v Janmor Nominees Pty Ltd* 87 ATC 4813 at 4818 per Lockhart, summarising the finding of Murphy J in the Victorian Supreme Court, a finding not upset on appeal.

41 The fact that assessable income is not derived until a later period does not preclude a deduction. This is because the phrase 'the assessable income' in s 51(1) has been held to apply to *assessable income generally*, not merely the assessable income of the accounting year in which the loss or outgoing was incurred: *John Fairfax & Sons Pty Ltd v FCT* (1958-1959) 101 CLR 30 at 45-46 per Menzies J.

42 *FCT v Kowal* 84 ATC 4001.

43 *FCT v Kowal* 84 ATC 4001 at 4008 per GN Williams J.

44 *Ure v FCT* 81 ATC 4100 at 4108 per Deane and Sheppard JJ.

serve to limit deductibility of current expense incurred with the object of gaining that income.

In conclusion, the authorities mandate that the negatively geared investment be aimed at producing assessable income at some future stage.

## (3) What mode of apportionment will the court adopt where it finds that the taxpayer's subjective purpose in entering the negative gearing arrangement is not motivated by the gaining of assessable income?

In these circumstances the courts' practice is to limit the deductibility of the outgoings to the amount of assessable income derived as a result of the outgoing.

This is apparent from the mode of apportionment adopted by Deane and Sheppard JJ in *Ure*:

> '...the appropriate apportionment was to treat the equivalent of what the taxpayer received from re-lending as being not of a private or domestic nature and to treat the balance of the interest paid by the taxpayer as being of a private or domestic nature.'[45]

Consider also *FCT v Groser*.[46] The taxpayer claimed a deduction for interest and other expenses in relation to his property rented to his invalid pensioner brother for $2 per week, whereas the market rental value of the property was $75 per week. The Victorian Supreme Court concluded that the $2 per week did not constitute rent, and therefore, was not part of the taxpayer's assessable income.

However, it went on to add that had the rent constituted assessable income of the taxpayer, the deduction allowable under s 51(1) would not exceed the amount included as assessable income ($2 per week).[47] This was because the subjective purpose of the taxpayer in entering the transaction was the provision of lodging for his invalid brother.

That this approach can also work in reverse is evident from *Kowal's* case.[48] In this case GN Williams J considered that the appropriate apportionment was to treat 80 per cent of the outgoings as having the characteristic of outgoings incurred in earning assessable income. His Honour further noted:

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45 *Ure v FCT* 81 ATC 4100 at 4111 per Deane and Sheppard JJ.

46 *FCT v Groser* 82 ATC 4478.

47 *FCT v Groser* 82 ATC 4478 at 4482 per Jenkinson J.

48 *FCT v Kowal* 84 ATC 4001.

> 'However, if 80 per cent of the outgoings was less than the actual amount of assessable income earned from the use of the borrowed funds, the appropriate deduction under sec 51(1) would be such portion of the outgoings *as equated the income earned.*'[49] (Emphasis added)

## (D) CONCLUSION

Therefore, no novel or innovative principles formed part of the High Court judgment in *Fletcher*. Authorities for over a decade have recognised the three major negative gearing principles propounded in this decision. If nothing else, *Fletcher* confirms the importance of purpose to s 51(1), the need for investments to be aimed at producing assessable income, and the appropriate mode of apportionment where the latter is not evident.

The High Court only broke new ground in specifying a clearly determinable threshold as the point where the objective purpose of the transaction is to be superseded by the evidentiary value of the taxpayer's subjective purpose. Even in this respect, the approach is not radical, but merely a recognition that where the nexus between expense and income is not apparent on the face of the transaction, the taxpayer's subjective purpose must determine the issue. The most obvious example of this situation is that provided by the High Court, where the investment generates an immediate loss. The court must then determine whether the taxpayer's purpose is the gaining of assessable income (albeit at some future time) or rather the attainment of objectives unrelated to this.

It is submitted that the High Court in *Fletcher* has adopted a well-founded, sensible and logical attitude to negative gearing. Consequently, a negatively geared transaction must attract an analysis of the taxpayer's subjective purpose in entering the transaction. The position of taxpayers involved in negative gearing has not changed as a result of *Fletcher*. The fears raised are unfounded. It remains necessary for these taxpayers to provide evidence of their purpose of gaining assessable income. This is merely the application of the first limb of s 51(1): where a link between the expense and income cannot be substantiated, no deduction will be allowed.

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49 *FCT v Kowal* 84 ATC 4001 at 4009 per GN Williams J.