Comments

A TAX INCENTIVE FOR THE CLEVER COUNTRY?

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In the light of increases in the cost of acquiring an education prior to entering the workforce in spite of government recognition of the necessity for education, it is time to consider using the tax system to encourage people to spend money on education. This comment introduces the concept of amortising higher education expenses over their useful life. This would involve recognising that education to acquire a skill is a capital asset distinct from the revenue-related expenditure on education to maintain such a skill.

At a time when government spending on education has dropped and universities are hard pressed to maintain educational standards (let alone improve the quality of education!), we have been told that we need to reshape ourselves to become the "clever country". No one questions the economic reasons for this – an educated workforce is needed to produce a stronger economy. The problem is how to finance educating the workforce with less government support.

If higher education institutions are to survive, it is clear that some form of "user pays" system is on the horizon. The Higher Education Contribution is a form of user payment, but clearly has not generated sufficient revenue. Consequently, universities are becoming more responsible for their own finances. This leaves them with little choice but to levy higher fees or actually charge for tuition. Even under the proposed voucher system, payments of some sort would have to be made by those not possessing enough vouchers to "purchase" the kind of education they desire.

But if a "user pays" system is introduced, how do we induce the users to incur the expense?

One way in which governments can induce citizens to engage in certain behaviour is by creating tax incentives.[1] Tax incentives generally take one of three possible forms: deductions, rebates or exemptions. Deductions, as reductions in the amount of assessable income, tend to favour those in higher income brackets who pay tax at a higher marginal rate. Rebates, on the other hand, are reductions in the amount of tax due. They are more equitable than deductions in terms of the benefit rendered. Exemptions essentially remove certain types of receipts from assessable income in an attempt to encourage taxpayers to engage in the activity that generates the receipt. Clearly deductions or rebates are more appropriate incentives in the case of education.

At present education expenses are deductible under s 51(1) if they are incurred in gaining assessable income. Under a traditional interpretation of s 51(1) this has required, first of all, that the student taxpayer has income to be offset by the deduction and, secondly, that the education expense be shown to be likely to produce assessable income. In other words there must be a nexus between the taxpayer's assessable income and her education expenses. Accordingly, a deduction is only available to those income-earning taxpayers undertaking continuing education calculated to move them forward in an existing career.[2] Even this deduction is limited by s 82A to the amount exceeding $250. Overall this policy offers very little encouragement to potential students engaged in initial career training.

This note surveys current tax attitudes towards education expenses and suggests a re-evaluation of those attitudes. It concludes by proposing amortisation of education expenses as an incentive to self-funded education.

Section 51(1) generates more litigation than any other section in the Income Tax Assessment Act. Simply put, s 51(1) allows deduction of expenses incurred in producing assessable income provided that the expenses are not of a capital or private nature.[3] Since the taxpayer's actual receipts are reduced by outgoings incurred to generate them, it is logical to allow deduction of those outgoings. It is equally logical that a capital expense, which by its very nature will continue to generate income for a period of time exceeding the tax period in which it was made, is not fully deductible in that period.

Given the simplicity of s 51(1) it is curious that so many of its facets have been questioned. None the less, application of s 51(1) to education expenses may safely be reduced to determining, first, whether there is a

1 The attentive reader will, at this point, notice that tax incentives usually involve decreasing tax revenues, which exacerbates the fiscal problems of the government that led to decreased education spending to begin with. However, the incentive to be proposed will involve small revenue sacrifices over an extended period of time. The decrease in education spending need only be greater than the decrease in revenue for the government still to have a smaller education budget than it presently does.

2 See, eg, *FC of T v Finn* (1961) 106 CLR 60 (government-employed architect allowed deductions for expenses incurred in travelling overseas to update and improve his knowledge in the field where this improved knowledge enhanced his prospects for promotion).

3 Since this note is concerned with education expenses, it is unnecessary to consider the second limb of s 51(1). See, eg, *FC of T v Finn*, above n 2.

nexus between the expense and the income-generating activity, and, secondly, whether the expense is disqualified by virtue of its capital or private nature.

In considering the nexus question, courts have required that the taxpayer be in an established career and that the education expenditure be calculated not just to maintain that career but, rather, to ensure advancement. The leading case for this proposition is *FC of T v Finn*,[4] in which the taxpayer was able to make out that by incurring the expense, he was more likely to receive a promotion and raise in pay.

Courts have not sought a close temporal connection between the expenditure and the assessable income. Provided that the taxpayer was already earning income, the courts have not required a showing of increased earning in the year in which the education expenditure was incurred. The likelihood of additional assessable income was sufficient.[5]

The one exception to this has been where the employer has required the education expenditure as a term of employment.[6] In this case the prospect of additional income becomes unnecessary. This principle has been extended to AUSTUDY recipients, who are, in effect, being paid to pursue a course of study. Since AUSTUDY allowances are taxable income, any education expenses incurred in pursuing the course of study become deductible.[7]

In *FC of T v Finn*,[8] Dixon CJ was asked to consider whether an expenditure on continuing education was capital and stated that improving one's knowledge could not be considered equivalent to extending a factory's physical plant.[9] Knowledge fades, while bricks and mortar do not, he reminds us.

Menzies J also discussed this question in *FC of T v Hatchett*.[10] Here, too, his discussion was not so much presentation of a logical argument as it was a mere assertion that "human capacity is entirely different from 'capital'".[11] Nowhere does Menzies J actually distinguish the expenditure made to establish the plant for production of income from the expenditure made to establish the skill to produce income. In fact, his reference to "human capacity" indicates that he does not distinguish training the mind from the capacity of the mind to be trained. This is rather disappointing, considering

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4 Above n 2.

5 *FC of T v Finn*, above n 2. See also *FC of T v Wilkinson* (1983) 14 ATR 218 (air traffic controller allowed to deduct cost of flying lessons where pilot's licence improved his opportunities for promotion and he was, in fact, promoted).

6 See, eg, *FC of T v White* (1975) 75 ATC 4018.

7 IT 2412 (18 June 1987).

8 Above n 2.

9 Above n 2 at 69.

10 (1971) 71 ATC 4184.

11 The question of what is a capital expenditure is a difficult one that has vexed many courts. Most education expense cases were decided at a time when capital transactions were completely exempt from taxation and the distinction between income and capital was often manipulated to produce the desired result. This may serve to explain why those courts that have discussed the question with respect to education expenses have not dealt with it in any depth.

that he surely would recognise the difference between a pile of bricks and a building constructed from those bricks.[12]

In the light of established case law on the point it seems possible to divide education (and the expenses of acquiring it) into two categories. The first is education to establish a new skill or improve an existing skill. This can be considered equivalent to building a factory, extending an existing building, buying a new machine, or possibly trading in an old machine for a modern one. The second category is education to maintain existing skills. This is equivalent to maintenance of the factory as parts of it wear out or, to use Dixon CJ's word: "fades". Clearly one of these expenditures is capital while the other is not.

Under the existing interpretation of the Income Tax Assessment Act only the latter type of education expense is deductible. If the analogy is correct, this is as it should be. Maintaining an income-producing asset is a deductible cost of producing income. If, however, the former type of expense is indeed a capital expense calculated to generate income for years to come, consideration should be given to permitting the amortisation of this expense.[13]

Essentially, amortisation involves reducing the balance by periodic adjustments. In accounting amortisation is a periodic adjustment to reflect the diminished value of an item due to ageing or wear and tear. The phenomenon of the value of an item declining over time is known as depreciation.

As an example of the value of an education declining over time it should be noted that many professional groups, such as educators and solicitors, are required to engage in continuing education merely to maintain their qualifications. If their education were not wearing out, as capital assets do, this would not be necessary. This offers further support for the notion that education is a depreciable capital asset.

Section 54 sanctions deductions due to depreciation of "plant or articles owned by a taxpayer and used" to produce assessable income. This provision complements s 51(1) in so far as it allows for deduction of the expense of acquiring an income-producing capital item over the period of time for which the item is (or should be) used to produce income. Functionally the section poses two questions: whether the item sought to be depreciated constitutes plant or articles and whether the item is used to produce assessable income.

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12 Note that in *John Fairfax & Sons Pty Ltd v FC of T* (1959) 101 CLR 30, 54-55, Menzies J quoted Viscount Cave LC in *British Insulated and Helsby Cables Ltd v Atherton* [1926] AC 205, 213-214: "When an expenditure is made, not only once and for all, but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade, I think that there is a very good reason for treating such an expenditure as properly attributable not to revenue but to capital".

13 This idea has also been floated in other jurisdictions, cf Argrett, "Tax Treatment of Higher Education Expenditures: An Unfair Investment Disincentive" (1990) 41 Syracuse LR 621.

As a general rule of thumb it would appear that to qualify as plant or articles the item must actually be the means of income production, as opposed to merely providing a setting for income-producing activities. "Where the question has been whether buildings, structures or the like or parts of them, constitute plant, [it must be determined] whether the function performed by the thing is so related to the taxpayer's operations or special that it warrants it being held to be plant."[14] In the case of higher education, which generally equips one with specific knowledge or skills, the function of the education is very closely related to the generation of income.

One possible reason that courts have found the question of education expenses difficult is because of the difficulty in quantifying it.[15] We should not be intimidated by the fact that what we are dealing with is intangible. Other intangible property, intellectual property in particular, has been sufficiently quantified to be recognised as a capital asset to receive similar tax treatment.[16]

Undoubtedly quantifying education is a difficult necessity if amortisation is to be allowed. If, as a policy matter, the goal is to encourage taxpayers to seek training above and beyond a basic education, then education beyond whatever level of education is determined to be basic would become a capital asset that will depreciate over time.

As with any other capital asset depreciation cannot take place until the asset is in use or is installed ready for use. In the case of education this would normally be the time when the course is completed. Since most programmes of higher education require more than one year to complete it will probably be necessary for the value of the education to accumulate for a few years before it is used. This is consistent with depreciation of capital assets that require a long period of time to be constructed, and also with judicial attitudes toward expenditure on capital assets during a time when no income generating activity is carried out.[17]

Taking this approach also resolves the potential problem of the personal nature of education. Once education has been used in earning income the extent to which the education was personal is greatly diminished. Of course, some courses of study are more personal than others: for example, one is more likely to study philosophy or ballroom dancing for personal reasons, while one usually studies law or medicine in the expectation of generating income. Again the general test for depreciation: "in use or installed ready for use" will provide demarcation.

Statisticians tell us that people tend to change careers every ten years or so. This is an indication of the useful life of an education, although further

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14 *Macquarie Worsteds Pty Ltd v FC of T* (1974) 74 ATC 4121, 4125 per Mahoney J.

15 The fact that Menzies J did not distinguish training from the capacity of the mind to be trained is illustrative.

16 See in particular the Income Tax Assessment Act 1936, Part III, Division 10B; cf the Income Tax Assessment Act 1936, Part IIIA, Division 14.

17 "Plant acquired in a year in which no business or income-producing activity is carried on does not qualify for depreciation in that year". *Case L52* (1979) 79 ATC 384 (typewriter acquired for use in business not yet in existence cannot be depreciated).

work is necessary to designate useful life and to ascertain whether different types of education have different useful lives just as different types of machinery have different useful lives.

As previously mentioned, either a deduction or a rebate would be appropriate as a tax incentive. Which is more appropriate is an issue beyond the scope of this note. It should, however, be noted that either can be drafted to be more, or less, equitable. For example, while deductions generally favour those in higher tax brackets, if the deduction were limited to x percent of assessable income, that favouritism would be effectively removed. Further, from a revenue point of view, deductions represent a lesser loss to the fisc.

So far this proposal has been discussed as if it could be implemented merely through re-evaluation of existing legislation. While this may be possible, it is not probable. It is more likely that a specific sanction, along the lines of Division 10B regarding Industrial Property, would be required. Such a specific provision could deal with many of the difficulties that have been raised, but not resolved, herein.