TD 93/29 - Income tax: if an employee incurs legal expenses recovering wages paid by a dishonoured cheque, are these legal expenses an allowable deduction under section 8-1 of the Income Tax Assessment Act 1997 ?

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Generated on: 5 June 2026, 03:33:30 AM

Australian Taxation Office

Taxation Determination TD 93/29

This Determination, to the extent that it is capable of being a 'public ruling' in terms of PartáIVAAA of the *Taxation Administration Act 1953*, is a public ruling for the purposes of that Part . Taxation Ruling TR 92/1 explains when a Determination is a public ruling and how it is binding on the Commissioner. Unless otherwise stated, this Determination applies to years commencing both before and after its date of issue. However, this Determination does not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of the Determination (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

*[**Note:** This is a consolidated version of this document. Refer to the ATO Legal Database (http://law.ato.gov.au) to check its currency and to view the details of all changes.]*

Taxation Determination

Income tax: if an employee incurs legal expenses recovering wages paid by a dishonoured cheque, are these legal expenses an allowable deduction under section 8-1 of the *Income Tax Assessment Act 1997*?

1. Yes, providing that the legal action relates solely to the recovery of wages. This is because in deciding '... whether expenditure has the character of a capital or of a revenue payment ... the advantage for which the expenditure was incurred must be identified and the manner in which it "is to be relied upon or enjoyed" must be considered ...'. (*Magna Alloys & Research Pty. Ltd. v. FC of T* 80 ATC 4542 at 4548; 11 ATR 276 at 283).

2. Salary or wage income is only assessable when it has been derived, and salary or wages are generally derived when paid. In *Tilley v. Official Receiver in Bankruptcy* (1960) 103 CLR 529 at 535 Kitto J, in an observation concerning payment by cheque, stated that ' There can be no doubt that the acceptance of a payment by cheque implies, if there be nothing to the contrary, an agreement that it shall be considered as payment, subject to the condition subsequent that if the cheque be dishonoured it shall no longer be so considered ...'.

3. Accordingly, where salary or wages are paid by cheques which are subsequently dishonoured, no income has been derived, but the employee still has an enforceable right to recover the amount owing. If legal expenses are incurred in pursuing the amount owing, those legal expenses are directly incurred in the process of deriving assessable income. Consequently, they are deductible under section 8-1 of the *Income Tax Assessment Act 1997*.

4. Examples of costs which may be claimed include:

Solicitor's fees in pursuing the debt in court; Court costs; Costs associated with serving a legal process.

5. However, if the legal action goes beyond a claim for a revenue item such as wages, and constitutes an action for breach of the contract of employment where the essential character of the advantage sought relates to an enduring advantage that is of a capital nature, the legal costs would not be deductible. For example, legal expense relating to an action for damages for wrongful dismissal are not deductible.

6. There will often be occasions where the legal expenses are incurred in relation to proceedings that relate both to amounts that are revenue in nature as well as amounts which are capital in nature. For example, many proceedings in relation to wrongful dismissal will also involve the recovery of unpaid salary or wages. In these circumstances ' ... there must be some fair and reasonable assessment of the extent of the relation of the outlay to assessable income' (*Ronpibon Tin N.L. v. FC of T* (1949) 78 CLR 47 at 59).

6A. A deduction for legal expenses by an employee depends on the particular facts of any case. To be deductible the occasion of the expenditure must be found in what is productive in the gaining of assessable income by the employee. If expenses are incurred to dispute the receipt of income contractually owed under an employment contract, then the expenses are on revenue account and allowable as a deduction.

7. Where the solicitor's account is itemised, one reasonable basis for apportionment would be the time spent involving the revenue claim, relative to the time spent on the capital claim. If the solicitor's account is not itemised, a possible basis for apportionment would be either a reasonable costing of the work undertaken by the solicitor in relation to the revenue claim, or, where this is not possible, an apportionment on the basis of the monetary value of the revenue claim relative to the capital claim.

Example:

Andrew B is dismissed by his employer. He consults a solicitor who advises that he is entitled to wages, severance pay and damages for wrongful dismissal. The solicitor sends a letter of demand for payment of $5,000 (wages and severance pay) and institutes legal proceedings in respect of the wrongful dismissal. Upon receipt of the letter of demand, the employer pays the amount of $5,000, but he decides to defend the action for wrongful dismissal. After 15 months of negotiations, Andrew receives a further $5,000 for wrongful dismissal in an out-of-court settlement. He also receives an account from his solicitor for $3,000, which he pays. The account is not itemised.

Andrew includes a deduction of $100 for legal expenses in his return. This amount is acceptable because only one letter was written by the solicitor to recover the wages and severance pay. The balance of $2,900 is not deductible.

If the letter of demand had not resulted in payment, and legal proceedings had been instituted which led to a settlement of $5,000 for wages and severance pay, as well as $5,000 for wrongful dismissal, a deduction of $1,500 would be reasonable, the apportionment being based on the size of the revenue amount relative to the capital amount.

Commissioner of Taxation
18/2/93

FOI INDEX DETAIL: Reference No. I 1214162 Previously issued as Draft TD 92/D222
Related Rulings:TD 92/201
Subject Ref: legal expenses; employees; litigation
Legislative Ref: ITAA 1997 8-1
Case Ref: Magna Alloys & Research Pty. Ltd. v. FC of T 80 ATC 4542 ,11 ATR 276; Tilley v Official Receiver in Bankruptcy (1960)103 CLR 529; Ronpibon Tin N.L. v. FC of T (1949) 78 CLR 47
ATO Ref: NEW TD24
ISSN 1038 - 8982