CAPITAL OR INCOME

B.P. Australia v. Federal Commissioner of Taxation [1966] A.C. 244 and **Regent Oil Co. Ltd** v. **Strick** [1966] A.C. 295

On 27 July 1965, five Lords of Appeal in Ordinary delivered judgments in two income tax cases: *B.P. Australia Ltd* v. *Federal Commissioner of Taxation* [1966] A.C. 244 P.C. and *Regent Oil Co. Ltd* v. *Strick (Inspector of Taxes)* [1966] A.C. 295 H.L.[1]

In each case an oil company had paid lump sums to service station proprietors or retailers for agreements by the retailers to buy and sell only that oil company's products for a period of years. The oil company had attempted to deduct the sums so paid from its assessable income for tax purposes. As the Judicial Committee of the Privy Council the Law Lords held that the sums paid by the oil company were revenue expenditure deductible for tax purposes and as the House of Lords they held that the payments were capital payments so that such deduction was not permissible. The main factual differences between the two cases were: (a) in the Privy Council case (the *B.P.* case) the duration of the tie agreements was taken as being five years whereas in the House of Lords case (the *Regent* case) the duration was for five, ten, and in two instances twenty-one years respectively. (b) In the *Regent* case the tie agreements took the form of a lease from the retailers to the oil company, the term being the duration of the tie, for a lump sum premium and a nominal rent, and a sub-lease back from the oil company to the retailer for the full term less three days at the same nominal rent. The sub-leases incorporated covenants by the retailers to abide by the terms of the tie agreements on pain of forfeiture of their sub-leases for non-compliance. However in the *B.P.* case there was merely a simple contract giving the oil company no interest in land. In the *Regent* case the House of Lords held unanimously that the interest in land conferred on it by the lease-sub-lease arrangement was conclusive against the oil company. This note is concerned only with point (a).

Criticism

Two points in particular deserve attention, namely: (a) the refusal, as it seems to the writer, of the Privy Council and Lords Reid and Upjohn in the *Regent* case to regard tangible and intangible assets as subject to the same rules for determining whether they are fixed or circulating capital assets, and (b) the view taken by both the Privy Council and the majority in the House of Lords that payments for

1. See Whiteman [1966] B.T.R. 115. The only New Zealand case in which these cases have been judicially considered seems to be *Maney and Sons Ltd* v. *C.I.R.* [1967] N.Z.L.R. 41.

short-term ties could be revenue but for long-term ties must be capital expenditure; i.e. that a short-term tie could be a circulating capital asset but a long-term tie must be a fixed capital asset.

In neither case was there an express statutory provision permitting deduction of the payments in question. Therefore they could be deducted only if they were, in the strict economic sense, revenue and not capital expenditures. In the absence of an express statutory provision to the contrary, a payment can only be deducted from assessable income for tax purposes if it first qualifies as a revenue payment in the strict economic sense.

The premise on which the two decisions were based is that in *all* cases where it must be determined whether an asset or payment is capital or revenue:

> No one test or principle or rule of thumb is paramount . . . It is a commonsense appreciation of all the guiding features which must provide the ultimate answer.[2]

To the writer a more satisfactory approach is to ask: What is the functional relationship between the advantages to the firm derived by possessing the asset in dispute and the firm's profit-yielding process? It may not always be possible to give a clear answer to this question; but, if it can be answered, then that answer is conclusive. No "appreciation of all the guiding features" can ever turn what is by that test a fixed capital asset to a firm into a circulating capital asset or vice versa.

It is clear that tangible and intangible assets were considered to be quite distinct for the purpose of determining whether they were fixed or circulating capital assets. Previous cases concerning tangible assets were regarded as providing "no safe analogy" to the present case, but no reason was given. There appears to be no reference to this distinction in any earlier case or in any text-book, or even in the arguments of the oil companies' counsel.

Because the Law Lords considered that all the guiding features had to be taken into account it is difficult to specify one particular factor seen by their Lordships as being decisive.

Tangible and Intangible Assets

The reason given by the Privy Council for refusing to regard tangible and intangible assets alike for the purpose of classifying them as fixed or circulating capital assets seems to have been as set out at 268:

> Tangible assets are prima facie durable objects and part of the structure within which the profit-yielding process is carried out. By convention and practice they are placed in the balance sheet and their

2. [1966] A.C. at 313 F (per Lord Reid) and 264 E (per Lord Pearce delivering the opinion of the Privy Council).

> diminution in value is acknowledged and accommodated by a system of capital depreciation for revenue purposes. No such clear practice or convention exists with respect to choses in action.

It is submitted that it is misleading to say that tangible assets are prima facie part of the structure of the profit-yielding process; a pound of butter is not prima facie part of the profit-yielding structure of a grocery business.

On the other hand there is an established convention that some intangible assets such as goodwill, are always placed in the balance sheet and, if possible, gradually written off. Of more significance, these conventions and practices have not hitherto been regarded as conclusive. In this respect it is important to distinguish between cases wherein established accounting convention was diametrically opposed to the proposed rule and cases wherein no established accounting convention is involved. Certainly to hold a payment to be capital when it is by all accounting conventions revenue would require extremely compelling reasons—perhaps nothing short of legislative direction would be sufficient.[3] Even in such cases as *Minister of National Revenue* v. *Anaconda American Brass Co. Ltd* [1956] A.C. 85 P.C. and *I.R.C.* v. *Duple Motor Bodies Ltd* [1961] 1 W.L.R. 739 H.L. the objection to the accounting system proposed was that it did not accurately reflect net profit whereas another established accounting system did. However, to refuse to classify an asset as fixed capital solely because no accounting convention had been established with respect to that particular type of asset is something altogether different. A compelling reason for such a refusal should be given. The Privy Council derived support for its decision that the ties were circulating capital assets from the fact that the sums paid to retailers were put by B.P.'s accountants in the profit and loss account. This, it is submitted, was an irrelevant consideration:

> It can never rest with the taxpayer to decide upon what principle his income is assessed for tax purposes.[4]

Lord Reid took the view at 317 that:

> If the asset which is acquired is in its intrinsic nature a capital asset, then any sum paid to acquire it must surely be capital outlay . . . . It appears to me, however, that an asset which is nothing more than a

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3. See e.g. *Arthur Murray (N.S.W.) Pty Ltd* v. *F.C.T.* (1965) 114 C.L.R. 314 H.C.A.
4. Lord Guest in the *Duple* case, supra, at p.757. If Lord Reid ([1966] A.C. at 313F) had not quoted Lord President Clyde in *Whimster & Co.* v. *I.R.C.* 1926 S.C. 20, 25 out of context the remainder of his judgment might have taken a different approach.

> right to enjoy a certain advantage over a period is intrinsically of a different character from a thing which a person buys and can immediately use or consume in any way he chooses.

Lord Reid's first sentence, it is respectfully suggested, is misleading in that it suggests that an asset is a fixed capital asset because of its "intrinsic nature". A new office block would be a fixed capital asset to most purchasers but to a person who bought and sold office blocks as a trade, an office block would be stock in trade and a circulating capital asset. The distinction between "rights" and "things" seems insubstantial as a test to decide whether an asset is a fixed capital one or not. If "rights" are to be regarded as circulating capital assets, no distinction can be drawn according to the length of the period over which the "right" is to be enjoyed. Yet this is what Lord Reid himself does. Secondly, a lease, for example, is nothing more than a right to enjoy certain advantages with respect to a piece of land over a period. If, as is common, the use to which the land can be put is stipulated in the lease and there is no right of assignment, such a lease would exactly fit Lord Reid's description, yet a premium paid for a lease is a capital outlay. Consequently some other distinction must be sought to justify the different treatment of tangible and intangible assets. The Privy Council thought at 271 that the ties would be "inappropriate" in the balance sheet because they would have to be depreciated out of tax-paid profits. Does this mean that whether an asset is a fixed capital asset or not depends, not upon its function in the profit-yielding process, but whether, if it were placed in the balance sheet as fixed capital, depreciation debited against it would be deductible for tax purposes? The Privy Council also thought at 274 that although payments for short-term ties could be revenue expenditure, payments for long-term ties must be capital expenditure, but it did not explain why it is appropriate that long-term but not short-term ties must be capitalised, or, alternatively, why, despite the inappropriateness of treating the ties as capital assets, long-term ties must be capitalised.

In dealing with the general issue Lord Upjohn in the *Regent* case at 345 said:

> A company may reasonably require and be prepared to pay for secured outlets for its products for some years ahead. . . . Another company . . . may want to assure itself of a constant supply of some vital component and be prepared to pay some supplier a lump sum to assure that supply. Such payments are not lightly to be held to be capital.

The example Lord Upjohn gives highlights the distinction hitherto recognised between payments made for a right. These payments had always been regarded as capital payments whereas payments made in

exploiting that right had always been regarded as revenue.[5] In the *B.P.* and *Regent* cases the decisions in point were either doubted or distinguished as "special" cases, but the writer respectfully agrees with Lord Wilberforce at 353:

> these authorities do little more than provide illustrations of the character of various types of assets in various trades.

To avoid confusion in formulating principles determining whether an asset is fixed or circulating capital the courts should aim, as far as possible, at consistency.

It appears therefore that in neither the *B.P.* case nor the *Regent* case was any compelling justification given for treating tangible and intangible assets differently in order to determine whether they are fixed or circulating capital assets. On the contrary, in the writer's view, they should be treated alike. Once the advantages to the firm derived from possessing the asset in question have been ascertained, it should make no difference whether that asset was tangible or intangible. A tangible asset is not regarded as a fixed capital asset because it can be perceived with the senses but because of the function it performs in the profit-yielding process. The same should be true of intangible assets.

Long-term and Short-term Ties

The majority of the Law Lords[6] state expressly that long-term ties must be fixed capital assets but short-term ties could be circulating capital assets. Perhaps the view of their Lordships can be explained by considering this remark of Lord Reid's at 322:

> A variant of this argument is that a right which comes to an end during the financial year current when it is acquired is not enduring, but that any right which persists into the next financial year must be enduring . . . that would be absurd.

Lord Reid rightly rejects the reasoning adduced to support the argument presented. But it seems that the argument is based on a different and more fundamental fallacy; namely, that whether an asset is a fixed or a circulating capital one can depend upon the duration of its existence. Is not a new machine which produces a firm's product a fixed capital asset whether it lasts six months or twenty years? Likewise can

5. See *Stow Bardolph Gravel Co. Ltd* v. *Poole* [1954] 1 W.L.R. 1503; *H. J. Rorke Ltd* v. *I.R.C.* [1960] 1 W.L.R. 1132—both mining cases wherein payments made for the right to extract minerals were held to be capital expenditure, and *Henriksen* v. *Grafton Hotel Ltd* [1942] 2 K.B. 184—payment for a licensed victualler's licence to last three years held to be a capital payment.
6. Lords Reid (316 E-G) and Morris of Borth-y-Gest (334 G-335 A; a tie of less than a year "is so closely linked with the selling operations during that year that it becomes different in nature and does not qualify to attain "the dignity of a capital asset". This view is not consistent with the distinction noted infra between capital and revenue costs of production), Lords Pearce (336 B) and Upjohn (346 C-E) and the Privy Council (274 A-B).

a supply of stock in trade sufficient to last twenty years ever become a fixed capital asset?[7] It is suggested that the fallacy is based on a failure to distinguish clearly capital costs of production from revenue costs of production. In the example given of a machine which lasts for six months, it is essential in order to obtain a true and fair view of the firm's financial position, to set off against the revenue earned during the period of its productive life the total cost of the machine as depreciation. But this does not convert the machine into a circulating capital asset. The failure to distinguish revenue from capital costs of production may be due to the fact that accountants may "short-cut" all the book entries they would otherwise make and simply debit the whole cost of the machine as depreciation in the financial year during which it was acquired and exhausted without opening a whole new capital account for it. If, however, the machine was acquired in the ninth month of the accounting year and replaced in the third month of the next year a capital account for it would be opened, and at balance date one half of the cost of the machine, say, (depending on the method of depreciation adopted) would be debited as depreciation against the revenue earned during that year. The machine would then be entered at its depreciated value in the accounts for the subsequent year. The machine is a fixed capital asset no matter how long its productive life.

Likewise twenty years' supply of hub-caps will always be stock in trade and circulating capital assets to a motor car manufacturer and the price paid for the twenty years supply will be a revenue expense. The motor car manufacturer will ordinarily be entitled to deduct the whole sum from his assessable income for tax purposes in the first year—the year in which he incurred the liability.

Conclusion

It is accordingly contended:

(a) That there is no difference between tangible and intangible assets in determining whether they are fixed or circulating capital assets to a particular firm—the comparison is not to be made between the tangible and the intangible assets as such, but between the various advantages derived by the firm from possessing the assets

7. In 2 Simon's *Income Tax* 424 two pairs of cases are cited which at first glance would support the implication made in the text that frequency of occurrence may turn an item of otherwise capital expenditure into one of revenue expenditure. These are (a) *Morant* v. *Wheal Grenville Mining Co.* (1894) 3 T.C. 298 and *Bonner* v. *Basset Mines Ltd* (1912) 6 T.C. 146, (b) *O'Grady* v. *Bullcroft Main Colleries Ltd* (1932) 17 T.C. 93 and *Robert Addie and Sons* v. *C.I.R.* (1924) 8 T.C. 671. However when these cases are examined it is apparent that they do not support the text in *Simon* for the issue in both cases was not whether frequency of occurrence could turn a capital payment into a revenue payment but into which of two clearly recognised and different categories of expenditure, the one admittedly capital and the other admittedly revenue, the particular expenditure should be placed. It was purely a question of fact.

The other case deserving notice is the recent Privy Council decision in *Commissioner of Taxes* v. *Nchanga Consolidated Copper Mines Ltd* [1964] A.C. 948. This was not a case where competition was stifled but merely of an oligopolistic cartel arrangement more akin to a profit-sharing agreement than anything else.

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in question and the functional relationship between those advantages and the profit-yielding process of the firm.

(b) That if the "functional" test shows that an asset is a fixed or a circulating capital asset to a particular firm, the duration of that asset's existence is irrelevant.

(c) That contractual benefits to secure outlets or future supplies of goods in which the firm trades are fixed capital assets of a wasting nature which must be depreciated off out of annual profits over the duration of their existence, and whether that depreciation is tax-deductible or not is of no significance.[8]

In the light of the foregoing the writer contends that the reasoning in both the *B.P.* and the *Regent* cases concerning the classification of the ties as circulating capital assets in the former case and as fixed capital assets in the latter is unsatisfactory. The effect of these two decisions is not only to introduce greater uncertainty as to the practical application of the distinction between capital and income but to question the conceptual basis of the distinction itself.

V.R.W.G.

8. See per Lord Morris of Borth-y-Gest at 334 F.