The time element in deductions cases

John Prebble*

I. INTRODUCTION

In New Zealand, the general test of whether a particular item is deductible in calculating the assessable income of a taxpayer is found in section 104 of the Income Tax Act 1976:

> In calculating the assessable income of the taxpayer, any expenditure or loss to the extent to which it —
> (a) is incurred in gaining or producing the assessable income for any income year; or
> (b) is necessarily incurred in carrying on a business for the purpose of gaining or producing the assessable income for any income year —
> may, except as otherwise provided in this Act, be deducted from the total income derived by the taxpayer in the income year in which the expenditure or loss is incurred.

Section 104 is reinforced and made more specific by a string of more detailed provisions from section 105 to section 167A. Some of these are of general importance, such as section 106(1)(a) and (j) which, respectively, prohibit any deduction for expenditure in respect of capital or expenditure of a private nature. Others range in specificity and detail from section 114A which allows certain deductions in respect of devices installed in taxi-cabs to prevent passengers attacking their drivers, to section 108, which, in remarkably few words, lays down the general rules regarding deductions for repairs and depreciation.

This paper leaves aside all the sections that follow section 104, to concentrate upon section 104 itself. The focus is upon certain aspects of the general test of deductibility set out in section 104 which raise the issue of time. First, assuming the outgoing in question is a proper deduction, there is the issue of when it can be said to have become an item of "expenditure" and have been "incurred" by the taxpayer. Can an outgoing be estimated, and anticipated in the books of the taxpayer? Alternatively, can it be spread forward into the future? The first part of this paper will deal with these issues.

Secondly, there is the expense that is so removed in time from the income-producing activity by which it is occasioned that the question is whether that expense is deductible at all. Pre-trading and post-cessation expenses of a business are typical examples. These problems are considered in the latter parts of this paper.

II. "INCURRED"

In *New Zealand Flax Investments Ltd.* v. *F.C.T.,* Dixon J. held that " "Incurred" does not mean only defrayed, discharged, or borne, but rather it includes en-

* Senior Lecturer in Law, Victoria University of Wellington.

countered, run into, or fallen upon".[1] On the other hand, "it does not include a loss or expenditure which is no more than impending, threatened, or expected".[2] Thus, in *Stockvis* v. *F.C.T.*,[3] where a taxpayer submitted a dispute to arbitration and the case went against him, he did not "incur" his loss until the award was made. A corollary is that if a taxpayer first becomes liable for a revenue expense in, say, 1925, the expense is deductible in that year even though it relates to the income-producing activities of the taxpayer in, say, 1915 to 1920.[4]

The *New Zealand Flax* case was cited with approval in *F.C.T.* v. *James Flood Pty. Ltd.*,[5] and its test elaborated. An actual disbursement is not required, nor must there exist an immediate obligation enforceable at law. If there is a legal obligation, probably it does not need to be indefeasible. On the other hand, an inchoate liability subject to contingencies is not enough. The taxpayer must have "completely subjected himself" to the charge.[6] Consequently, sums set aside in a reserve fund to meet an anticipated liability are not deductible.[7] Generally speaking, expenditure[8] and losses[9] cannot be anticipated.

The principles in the *New Zealand Flax* and *James Flood* cases are illustrated by *Felt & Textiles Ltd.* v. *C.I.R.*[10] and *King* v. *C.I.R.*[11] Each case concerned long-term borrowing by the taxpayer and a claimed deduction in respect of related costs, pursuant to section 136 of the Income Tax Act 1976. That section authorises the deduction of "expenditure incurred . . . in the borrowing of money"; that is, its relevant terms are the same as those in section 104. To use representative sums for purposes of explanation, the taxpayer in *Felt & Textiles* borrowed $99.00 and in consideration promised to repay $100.00. In *King* he borrowed $99.00 and was charged a borrowing fee of $1.00. He added the fee to the principal, thus becoming indebted in a total sum of $100.00. In the first case, McGregor J. disallowed the $1.00 on the grounds, inter alia, that it was not "expenditure". In *King* v. *C.I.R.*, Wild C.J. allowed the $1.00 as "expenditure incurred" although the sum had not in fact been disbursed, following *F.C.T.* v. *James Flood & Co. Pty. Ltd.*, which had not been cited to McGregor J. in the earlier case. *King* v. *C.I.R.* is to be preferred. The case makes it clear that one can "incur" an expense simply by becoming indebted for the sum in question.[12]

1 (1938) 61 C.L.R. 179, 207.
2 Idem.
3 (1930) 1 A.T.D. 9; see also *Peter Merchant Ltd.* v. *Stedeford* (1948) 30 T.C. 496.
4 *Worsley Brewery Co. Ltd.* v. *I.R.C.* (1932) 17 T.C. 349 (accountancy fees relating to earlier years); *I.R.C.* v. *Titaghur Jute Factory Co. Ltd.* [1978] S.T.C. 166.
5 (1953) 88 C.L.R. 492, 507.
6 Idem. See the discussion 506-508.
7 *Mersey Docks & Harbour Board* v. *Lucas* (1883) 8 App. Cas. 891.
8 *Whimster & Co.* v. *I.R.C.* 1926 S.C. 20.
9 By virtue of s. 85(4) and (5) there is an important exception in respect of losses in value of trading stock, which may be taken into account pursuant to the rules in those subsections before the losses are realised on disposal of the stock.
10 [1969] N.Z.L.R. 493.
11 [1974] 2 N.Z.L.R. 190.
12 But see *Caltex Ltd.* v. *F.C.T.* (1960) 106 C.L.R. 205, where, on the facts, a borrowing was held not to be, in substance, the incurring of an obligation.

III. "EXPENDITURE OR LOSS"

There is a question logically anterior to the issue of whether expenditure has been "incurred". That is, whether the outgoing in question has become sufficiently certain to be called "expenditure or loss" at all. It appears that to be considered an expenditure or loss, an item does not need to have been actually disbursed. However, the item in question must exist. Thus, where a company issues shares at par when their market value is above par, the company has not incurred an expenditure or loss of the difference in value.[13] This particular situation is now mitigated by section 166 of the Income Tax Act 1976 in respect of companies operating employee share purchase schemes approved under that section. Companies are permitted to deduct notional interest on borrowings notionally made to finance share purchases by employees. Be that as it may, the general principle remains the same. An expenditure or loss does not exist simply because one has failed to make a profit that might have been made in other circumstances.

IV. DEDUCTIBILITY OF ESTIMATED LIABILITIES

Sometimes, a taxpayer will incur a legally enforceable liability without knowing the exact sum involved. A common example is an obligation to pay pensions or holiday pay calculated by reference to an employee's length of service. Often, such obligations cannot be reckoned exactly because of the possibility of forfeiture by the employee concerned for, say, dismissal for cause.

In *Southern Railway of Peru Ltd.* v. *Owen*,[14] the House of Lords held that a deduction could be allowed in respect of accrued pension rights, provided that the obligation could be, and was, fairly quantified. There should be a proper allowance for the possibility of forfeiture, and pensions payable in the future should be discounted actuarially. On the facts, the deduction was disallowed because the taxpayer's estimates were insufficiently precise.

The *Southern Railway* case turned on a United Kingdom rule forbidding deductions "in respect of any disbursements or expenses, not being money wholly and exclusively laid out or expended for the purposes of the trade, profession, or vocation". This language appears to impose a more stringent test of deductibility than that set out in section 104 of the New Zealand Income Tax Act 1976 and in the equivalent provision of the Australian Act, from which section 104 was copied. Consequently, the *Southern Railway* case should be good authority in New Zealand. However, it is not easy to reconcile the decision with *F.C.T.* v. *James Flood Pty. Ltd.*[15] There, the High Court of Australia disallowed a deduction in respect

13 *Lowry* v. *Consolidated African Selection Trust Ltd.* [1940] A.C. 648; cf. *Emu Bay Rly. Co. Ltd.* v. *F.C.T.* (1944) 71 C.L.R. 596; contrast *Northern Roller Milling Co. Ltd.* v. *C. of T.* [1953] N.Z.L.R. 517.

14 [1957] A.C. 334; cf. *London Cemetery Co.* v. *Barnes* [1917] 2 K.B. 496 (present value of perpetual obligation to maintain graves deductible from lump sum fees); *Cowen* v. *I.R.C.* (1934) 19 T.C. 155; but see *N.Z. Flax Investments Ltd.* v. *F.C.T.* (1938) 61 C.L.R. 179.

15 (1953) 88 C.L.R. 492; followed in *F.C.T.* v. *Nilsen Porcelains (Australia) Pty. Ltd.* (1979) 10 A.T.R. 255.

of accrued holiday pay, on the basis that the employees might forfeit their rights for a variety of reasons, including strikes, absenteeism, and dismissal for cause. As discussed earlier,[16] the *Flood* case is generally authoritative on the meaning of "incurred". But on the question of the degree of accuracy required in calculation before an expenditure qualifies to be deducted, *Southern Railway of Peru Ltd.* v. *Owen* is to be preferred. In practice, the New Zealand Commissioner allows a deduction for accrued holiday pay calculated in accordance with the relevant industrial award or legislation.[17]

Without citing the case, Menhennit J. applied the general principles of *Southern Railway of Peru Ltd.* v. *Owen* and distinguished *F.C.T.* v. *James Flood Pty. Ltd.* in *R.A.C.V. Insurance Pty. Ltd.* v. *F.C.T.*[18] His Honour allowed the taxpayer motor insurance company a deduction in respect of estimated personal injury indemnification claims arising from accidents that had been reported, but from which no claim had yet arisen, and even from accidents not yet reported, but whose occurrence within the income year in question was statistically predictable. By the terms of the insurance policies concerned, the company's obligation matured immediately the insured loss was suffered. Statistically, one could predict the sum of the company's liability with sufficient accuracy. The justice of Menhennit J.'s decision is evident when one considers the result had the company decided to terminate its insurance business at the end of any particular tax period. In these circumstances, the company would have had to bring its total premium receipts into the accounts for its last year of business. But it would have no future premiums against which to set off its liabilities to those who had paid their premiums and suffered insured losses that had not come to the notice of the company by the end of the tax year.

In making an estimate of expenses to be deducted according to the principles discussed above, it is permissible to take account of facts discovered after the end of the financial year.[19] Logically, the final deadline would appear to be the date for objecting to the Commissioner's assessment of one's income tax pursuant to section 30 of the Income Tax Act 1976.

Often a taxpayer's estimate of his expenditure or loss will in the event prove to be incorrect. But previous years' returns can be re-opened only in limited circumstances. Consequently, it seems that appropriate adjustments should be made in the income calculations of the year in which the funds are actually disbursed.[20] It is not easy to see statutory authority for this admittedly sensible interpretation, either in section 104, or in section 151 of the Australian Income Tax Assessment Act 1936. Moreover, the suggested rule may not be appropriate in cases where a long-term liability has been calculated by discounting for present value. The object of that procedure is, presumably, finally to fix the correct sum to be deducted in the current year.

16 See text accompanying ns. 1-7, supra.
17 C. A. Staples *A Guide to New Zealand Income Tax Practice* (42 ed. Sweet & Maxwell, Wellington, 1982), para. 645.
18 (1974) 4. A.T.R. 610; cf. *Sun Insurance Office* v. *Clark* [1912] A.C. 443.
19 *R.A.C.V. Insurance Pty. Ltd.* v. *F.C.T.* (1974) 4 A.T.R. 610, 626.
20 Ibid. 618; *Texas Co. (Australasia) Ltd.* v. *F.C.T.* (1940) 63 C.L.R. 382, 465-466 per Dixon J.

Where a legal obligation is apparently incurred but estimation is impossible, the cases cited above support the view that a deduction is allowed when the obligation crystallises, or an expenditure is actually made. The rationale is that although the taxpayer has incurred an obligation in one sense, he has not incurred it in the sense required by section 104 until, at least, it is sufficiently certain to be quantified,[21] albeit by a reasonable estimate.

V. ACCRUALS ACCOUNTING AND DEDUCTIONS

As far as receipts are concerned, the general rule is that business must recognize income on an accrual basis. Suppose, for example, a taxpayer sells an item of trading stock in March 1982, allowing 3 months' credit. The account is duly paid in June of 1982. The sale, and resultant income receipt, must be brought into account in the income year ending March 1982. The fact that payment is not received until the following income year does not affect the position. From the discussion that has gone before, it will have been observed that section 104's authority for the deduction of expenses when they are "incurred" does not always fit neatly into the annual system of accruals accounting which is the basis of the calculation of income on the receipts side of the ledger. Thus, liabilities relating to past years are brought into account in the year in which they are first incurred.[22] The position regarding liabilities relating partly or wholly to future years is more complex. Literally, it is arguable that section 104 authorises the deduction of a liability as soon as it is incurred. But it appears never to have been suggested that, say, ten years' rent payable annually, which has been "incurred" in the sense that there is an enforceable lease signed in, say, 1980, can all be deducted in that year.

In reported judgments, the problem is hardly ever systematically addressed,[23] but the following principles may be extracted from the cases.

(a) If the liability relates solely to the revenue of the year in which it is incurred, it is deductible in full against that year's income (subject to discounting in appropriate cases) notwithstanding that:
   (i) It is not payable until a future year;[24]
   (ii) It is for recurrent future payments.[25]

   Usually, recurrent payments like wages or interest will be found to relate at least partly to the future accounting period in which they become payable.[26]

(b) Liabilities which relate partly or wholly to income production in future years and are annually recurring, like rent, wages, and interest, are deductible in the year in which the legal obligation for payment crystallises into an "immediate

21 *Peter Merchant Ltd.* v. *Stedeford* (1948) 30 T.C. 496.
22 See text accompanying ns. 1-7 supra.
23 An exception is Lord Reid's judgment in *Albion Rovers F.C. Ltd.* v. *I.R.C.* (1951) 33 T.C. 331, 341.
24 *Southern Railway of Peru Ltd.* v. *Owen* [1957] A.C. 334.
25 Idem.; *I.R.C.* v. *Titaghur Jute Factory Co. Ltd.* [1978] S.T.C. 166; contra *W. Nevill & Co. Ltd.* v. *F.C.T.* (1937) 56 C.L.R. 290, 302 per Latham C.J., 307 per Dixon J., 309 per McTiernan J. (obiter); disapproved *F.C.T.* v. *James Flood Pty. Ltd.* (1953) 88 C.L.R. 492, 507; and see *J. Gadsden & Co. Ltd.* v. *C.I.R.* [1965] N.Z.L.R. 385.
26 E.g. *Albion Rovers F.C. Ltd.* v. *I.R.C.* (1951) 33 T.C. 331.

liability".[27] This is not necessarily the income year to which the payment relates.[28]

(c) Liabilities which relate partly or wholly to income production in future years but are for a single payment, are deductible when incurred, even though payment is deferred.[29] This rule applies when recurrent payments, such as interest or rent, are commuted to a single payment in advance.[30]

(d) In general principle, it might be expected that taxpayers whose receipts are brought to account on a cash basis should treat their expenses in the same manner. In practice, this is usually done. Nevertheless section 104 specifically allows deductions as expenditure is "incurred", not "disbursed". Strictly, there is no authority for treating cash basis taxpayers differently from ordinary taxpayers.

(e) Where a taxpayer sells goods for a gross price, and allows a discount for prompt payment, it appears that the discount is not to be treated as a deduction under section 104, but to be subtracted from the price before the sale proceeds are ever brought to account.[31] In effect, the discount is thus treated on an accruals basis.

VI. NO SPREADING OF DEDUCTIONS UNDER SECTION 104 TO OTHER TAX YEARS

In *J. Gadsden & Co. Ltd.* v. *C.I.R.*[32] the taxpayer incurred deductible expenditure of 15,130 pounds in 1961, but claimed to deduct 10,000 pounds in that year. It appeared that the company intended to deduct the balance later. T. A. Gresson J. did not comment on the proposal, but it is hard to find authority for such a course. Section 104 permits a deduction "in the income year in which the expenditure or loss is incurred". While the taxpayer is not obliged to take a deduction then or ever, there is no authority for him to choose to delay his claim until a subsequent year. The benefit to a taxpayer from spreading a deduction forward would be to utilise personal and other exemptions which he loses in incurring and carrying forward net losses, having no tax from which to be exempted.

The taxpayer's approach in *J. Gadsden & Co. Ltd.* v. *C.I.R.* derives some support from *W. Nevill & Co. Ltd.* v. *F.C.T.*[33] There, the taxpayer company agreed to pay a golden handshake of 2,500 pounds to a director to get rid of him. A down-payment of 1,500 pounds was claimed, and allowed as a deduction by the High Court. The balance was payable at 100 pounds a month, secured by promissory

27 *Jolly* v. *F.C.T.* (1934) 50 C.L.R. 131, 137; *Albion Rovers F.C. Ltd.* v. *I.R.C.* supra n. 23.

28 *Vallambrosa Rubber Co. Ltd.* v. *Farmer* 1910 S.C. 519.

29 *King* v. *C.I.R.* [1974] 2 N.Z.L.R. 190.

30 *Felt & Textiles Ltd.* v. *C.I.R.* [1969] N.Z.L.R. 493 (first issue); for a different application of the same principle see *London Cemetery Co.* v. *Barnes* [1917] 2 K.B. 496; but see *Nonmus & Co. Ltd.* v. *C. of T. N.S.W.* (1928) 29 S.R.N.S.W. 209 (rent paid in advance deductible in future years to which it related. This case does not appear to have been followed).

31 *Ballarat Brewing Co. Ltd.* v. *F.C.T.* (1951) 82 C.L.R. 364.

32 [1965] N.Z.L.R. 385.

33 (1937) 56 C.L.R. 290.

notes. No claim was made to deduct payments maturing after the financial year in question, and the point was not argued, but all members of the court stated obiter that they believed that the monthly sums were not deductible until actually paid.[34] Moreover, in *Nonmus & Co. Ltd.* v. *C. of T. N.S.W.*,[35] the taxpayer was permitted to spread into current accounts a proportionate fraction of rent paid in advance in a previous year. Be that as it may, the obiter dicta in *W. Nevill & Co. Ltd.* v. *F.C.T.* were questioned in *F.C.T.* v. *James Flood Pty. Ltd.*,[36] and the *Nonmus* decision does not appear to have been cited or followed in later cases. It appears to have been wrongly decided and cannot prevail over the present explicit language of section 104.

Ex hypothesi, a deduction claimed under section 104 cannot be spread into earlier years, because until the expenditure is incurred it does not exist.

A number of provisions in the Act vary the "no spreading" rule in particular cases. Section 136 permits a premium paid for the lease of land to be spread over the term of the lease, and section 137 contains similar provisions in respect of leases of machinery. Other examples include section 132 and section 133 (fertiliser expenses) and section 142 (2) (patent acquisition). Section 138, on the other hand, allows certain payments for a tenant's non-compliance with a covenant to repair to be spread back up to three years into the term of the lease, and provides for consequential reassessment of the tax years affected.

VII. "IN" MEANS "IN THE COURSE OF"

To satisfy the test of deductibility laid down by section 104, expenditure or loss must be incurred "in gaining or producing the assessable income" or "in carrying on a business for the purpose of gaining or producing the assessable income". The important word is "in". It was held in *Amalgamated Zinc (de Bavay's) Ltd.* v. *F.C.T.*[37] that "in" in the Australian equivalent of section 104 must be interpreted to mean "in the course of", and not as "for the purpose of".[38] As Latham C.J. explained, the section permits the deduction of losses, and one does not purposely incur losses.[39] Since that case, this approach has been consistently adopted in Australia,[40] and in New Zealand since the forerunner to section 104 took its present form in 1968.[41] This interpretation applies in respect of both section 104(a)[42] and section 104(b).[43] Be that as it may, to establish just what relationship between expenditure and the income-producing process is required by the words "in the course of" has not proved an easy task.

34 Ibid. 302 per Latham C.J., 307 per Dixon J., 309 per McTiernan J.
35 (1928) 29 S.R.N.S.W. 209.
36 (1953) 88 C.L.R. 492, 507.
37 (1935) 54 C.L.R. 295.
38 Ibid. 303 per Latham C.J., 309 per Dixon J.
39 Ibid. 303; cf. *C. of T.* v. *Webber* [1956] N.Z.L.R. 552, 559.
40 E.g. *Ronpibon Tin N.L.* v. *F.C.T.* (1949) 78 C.L.R. 47, 57; *Lunney* v. *F.C.T.* (1958) 100 C.L.R. 478, 496.
41 *C.I.R.* v. *Banks* [1978] 2 N.Z.L.R. 472, 478.
42 Idem.
43 *Europa Oil N.Z. Ltd.* v. *C.I.R. (No. 2)* [1974] 2 N.Z.L.R. 737, 741 per Beattie J. This point was not disturbed on the subsequent appeal.

At least, the expenditure must be "incidental and relevant"[44] to the income-earning process. Richardson J. examined the question in some detail in *C.I.R.* v. *Banks*[45] and in *Buckly & Young Ltd.* v. *C.I.R.*[46] To be deductible, expenditure must have the necessary relationship "both with the taxpayer concerned and with gaining or producing his assessable income."[47] It is a matter of degree and fact whether there is sufficient relationship between expenditure and what it was for, and the income-earning process.[48] "The heart of the inquiry is the identification of the relationship between the advantage gained or sought to be gained by the expenditure and the income-earning process".[49] The burden of the remainder of this paper is an examination of this relationship so far as it is affected by questions of time. To over-simplify the issue, how closely must the expenditure be related to the income-earning process in point of time, in order to satisfy the requirements of section 104?

VIII. EXPENDITURE RELATED TO INCOME OF LATER YEARS

Section 104 states that expenditure which meets its criteria does not have to relate to income of the year in which it is incurred. Rather, it need only relate to "producing the assessable income for *any* income year" (emphasis added). Thus, for example, if a business buys a store of stationery in December 1981 that will last until June 1982, the total price can be deducted in the tax return for the year ended 31 March 1982. Apportionment is not necessary. This position has obtained since section 104 took its present form as section 12 of the Land and Income Tax Amendment Act 1968. Prior to that year, the former section, which was enacted by the Land and Income Tax Amendment Act 1922, had been held to forbid the deduction of expenditure that did not relate to income of the same year.[50] While the words of section 104 are now clear enough, there is ample authority on the equivalent Australian provision,[51] from which section 104 was copied, that supports the interpretation of section 104 adopted here by the author, and such has long been the position in the United Kingdom.[52] In relation to any continuing business it is the only practical solution. In fact, many types of expenses are incapable of allocation to the income of a particular accounting year. Expenditure on salaries, rent, trading stock, and consumable stores are obvious examples. Consequently, the Commissioner did not in practice apply the pre-1968 form of the legislation rigorously.[53]

44 *Ronpibon Tin N.L.* v. *F.C.T.* (1949) 78 C.L.R. 47, 56.
45 [1978] 2 N.Z.L.R. 472.
46 [1978] 2 N.Z.L.R. 485.
47 *C.I.R.* v. *Banks* [1978] 2 N.Z.L.R. 472, 476.
48 Ibid. 478.
49 *Buckly & Young Ltd.* v. *C.I.R.* [1978] 2 N.Z.L.R. 485, 487.
50 *Kemball* v. *C. of T.* [1932] N.Z.L.R. 1305, where it was held that the 1922 amendment reversed what had been held by the Privy Council to be the previous position in *Ward & Co. Ltd.* v. *C. of T.* [1923] A.C. 145.
51 *Ronpibon Tin N.L.* v. *F.C.T.* (1949) 78 C.L.R., 47, 56; *F.C.T.* v. *Finn* (1961) 106 C.L.R. 60, 68
52 *Vallambrosa Rubber Co Ltd.* v. *Farmer* 1910 S.C. 519.
53 *Report of the Taxation Review Committee* (The Ross Report) (Government Printer, Wellington, 1967) 196.

The classic illustration of the general principle is *Vallambrosa Rubber Co.* v. *Farmer*,[54] where the taxpayer successfully claimed to deduct expenses of planting, weeding, and other husbandry of young rubber trees that would not be productive for six or seven years. Apart from the vexed question of preliminary or start-up expenses of a business, which is to be considered below, it is now settled that expenses in relation to later years' income are deductible as incurred.

The better view is both section 104(a) and section 104(b) permit the deduction of expenditure related to later years. However, it has been pointed out by Dixon C.J. that the language of section 104(b) is particularly apt to cover the case where a business has not yet produced assessable income, or fails ever to do so.[55] It speaks of "carrying on a business" in the course of which one must incur expenses that cannot be related to a particular income year.

IX. EXPENDITURE RELATED TO INCOME OF EARLIER YEARS

Cases where a taxpayer claims to deduct an expense on the basis that it was occasioned by an income-producing activity of an earlier year are less common. The reported judgments appear to distinguish several different fact situations, depending on whether the taxpayer has income from one source or two. In the following table it is in each case assumed that in the course of an income-producing activity in year one, an expense is occasioned which is incurred by the taxpayer three years later in year four. The table is not exhaustive, but contains sufficient examples to illustrate the principles involved.

(a) The taxpayer has only one source of income throughout;
(b) Expense is occasioned by source A, but deduction is claimed against source B, source A having come to an end in, say, year two;
(c) Expense is occasioned by source A, but deduction is claimed against source B, because source A is showing a loss in year four.

Example (a) presents little difficulty. The typical case is where there is a continuing business, and the activities of an earlier year throw up an expense in a later year. Thus, in *Herald and Weekly Times Ltd.* v. *F.C.T.*[56] the taxpayer newspaper company claimed to deduct damages paid in respect of a libel it had published in an earlier income year. At that time, to be deductible, expenditure had to be "actually incurred in the gaining or producing of assessable income". Despite the strictness of this test as compared with the current New Zealand section 104, the High Court allowed the deduction. The principle that expenses occasioned by earlier activities can be deducted from later income of the same business has not been seriously questioned since.

In cases like example (b), where the taxpayer has discontinued the business that occasioned the expenditure, he has been less fortunate. The taxpayer in *Amalgamated Zinc (de Bavay's) Ltd.* v. *F.C.T.*[57] ceased its mining operations in

54 1910 S.C. 519.
55 *F.C.T.* v. *Snowden & Willson Pty. Ltd.* (1958) 99 C.L.R. 431, 436.
56 (1932) 48 C.L.R. 113. See also *Texas Co. (Australasia) Ltd.* v. *F.C.T.* (1940) 63 C.L.R. 382, 427, 428 per Latham C.J.
57 (1935) 54 C.L.R. 295.

1924, but continued to receive income from investments. It was obliged to maintain annual contributions to a workers' compensation fund. The revenue successfully challenged the deductibility of these payments for the years 1932 and 1933, on the ground that the income to which the payments related was of a past year. However, like the *Herald and Weekly Times* case, *Amalgamated Zinc* was decided on the old form of the Australian legislation, and its ratio must now be suspect.

In respect of its Australian equivalent, it has been pointed out that section 104(b) is not apt to cover the case where a business has ceased, but leaves behind it expenses cropping up in future years.[58] This is because section 104(b) applies to expenses incurred "in" (that is, "in the course of") carrying on a business. However, section 104(a) is not so limited.[59] The curious situation arises in respect of example (b) cases therefore, that expenditure occasioned by a business that has ceased is deductible, if at all, under section 104(a), rather than under section 104(b), the provision whose language more specifically refers to businesses.

A majority[60] of the Australian High Court in fact departed from *Amalgamated Zinc* in *A.G.C. (Advances) Ltd.* v. *F.C.T.*,[61] another case within the parameters of example (b). There the taxpayer was a hire purchase financier that got into difficulties. It entered a scheme with its creditors whereby debts owed to it were collected by an agent and handed over to the creditors. Some years later, with a new name, and new shareholders, and a new type of client, the taxpayer started a fresh business of hire purchase finance. At this stage, it wrote off some of its debts on the earlier business as bad and claimed to deduct the resulting loss in calculating the income of its new business. The revenue opposed the claim, relying on the *Amalgamated Zinc* case.

Barwick C.J. criticized and distinguished *Amalgamated Zinc*[62] and expressly agreed[63] with Mason J., whose judgment went deeper into questions of fundamental principle relating to the interpretation of section 51 of the Australian Income Tax Assessment Act 1936. That section is in almost the same terms as the New Zealand section 104, except that it omits the words "for any income year". Despite that omission, Mason J. held that one starts from the proposition that losses and outgoings are deductible without regard to accounting periods.[64]

Tying this proposition into the language of the statute, Mason J. held that a loss is "incurred" not only when it arises.[65] It is also to be regarded as "incurred" when it has its origin. In the *A.G.C. (Advances) Ltd.* case this was during the carrying on of the earlier business. His Honour supported this conclusion by reference to the much cited case of *Ronpibon Tin N.L.* v. *F.C.T.*,[66] where the

58 *Inglis* v. *F.C.T.* (1979) 10 A.T.R. 493, 502.
59 Idem.
60 Barwick C.J. and Mason J., Gibbs J. dissenting on this issue.
61 (1975) 132 C.L.R. 175.
62 Ibid. 187-188.
63 Ibid. 189.
64 Ibid. 197.
65 Ibid. 197-198.
66 (1949) 78 C.L.R. 47.

High Court had held that it was both sufficient and necessary to satisfy the legislation that the occasion of the loss or outgoing should be found in whatever is productive of the assessable income and, in respect of what is now the New Zealand section 104(b), that the occasion of the expenditure should be found in the carrying on of a business for the production of assessable income.[67] The occasion of the loss was the earlier business. Since deductibility does not depend on accounting periods, the loss could be deducted later, when it was in fact incurred. With respect, Mason J. is right. Any other approach entails the result that expenses in respect of past income years are deductible only where there is a continuing business.[68] Admittedly, courts have not always shrunk from requiring there to be a continuing business before allowing a deduction.[69] But there is no mandate for such an interpretation in the language of either the New Zealand or the Australian legislation. Moreover, it leads to an illogical result, as may be seen from an examination of example (c).

On the facts of example (c), one has a taxpayer with a business which incurs an expense in year four, the expense having been occasioned in year one. The business is making an over-all loss in year four, and thus the expense cannot be offset against its continuing income as in *Herald and Weekly Times Ltd.* v. *F.C.T.*[70] Nevertheless, since the business is continuing, it appears from the *Amalgamated Zinc* case that the expenditure can be deducted from other income of the taxpayer, if he has any. That is, the ratio of *Amalgamated Zinc* would treat examples (b) and (c) differently. This conclusion must be wrong, particularly in view of the current language of section 104, which makes it tolerably clear that:

(a) Expenditure is currently deductible if incurred in respect of income-producing activities of *any* year; and
(b) Expenditure and losses incurred in respect of income from one source may be set off against income from another source.

The line adopted by Mason J. in *A.G.C. (Advances) Ltd.* v. *F.C.T.* is also supported by the longstanding authority of Dixon J. in *W. Nevill & Co. Ltd.* v. *F.C.T.*[71] There, the taxpayer company persuaded one of its two joint managing directors to retire, for the good of the company. He was paid off with 2,500 pounds. In contending that this sum was not deductible, counsel for the revenue argued that the sum was incurred to save a future outlay rather than for purposes of producing income. But Dixon J. held that a wide view should be taken. The initial appointment of the director was in order to help the company to earn income. Expenses incurred in persuading him to retire were consequent upon that original income-earning purpose, and therefore deductible.[72]

67 Ibid. 57.

68 This is, in fact, the position in the United Kingdom, where the legislation is different and the test more stringent: *Godden* v. *A. Wilson's Stores (Holdings) Ltd.* (1962) 40 T.C. 161.

69 *Amalgamated Zinc (de Bavay's) Ltd.* v. *F.C.T.* (1935) 54 C.L.R. 295; *Texas Co. (Australasia) Ltd.* v. *F.C.T.* (1940) 63 C.L.R. 382, 428 per Latham C.J.

70 (1932) 48 C.L.R. 113. See text accompanying n. 56, supra.

71 (1937) 56 C.L.R. 290.

72 Ibid. 307.

X. PERSPECTIVE FROM WHICH DEDUCTIBILITY IS EXAMINED

The reasoning in *A.G.C. (Advances) Ltd.* v. *F.C.T.*[73] and *W. Nevill & Co. Ltd.* v. *F.C.T.*[74] can only be taken so far. The situation wherein an expense finds its origin is only one factor in determining its deductibility, as is shown in *C.I.R.* v. *Banks.*[75] There, the taxpayer had borrowed money on mortgage to buy his house. Since the property was used exclusively as his home, interest payments were not deductible. Later, he started to use part of the house for income-producing purposes. The Court of Appeal held that an appropriate proportion of the mortgage interest was deductible.

Delivering the judgment of the court, Richardson J. explained that in applying section 104, a court is concerned with the facts "as at the time the taxpayer became definitively committed to the expenditure".[76] Inferentially, in cases concerning servicing expenditure, such as rates and mortgage payments, this is to be taken as the time when those payments fall due.[77]

Be that as it may, while the court looks at the facts from the viewpoint of the time of the incurring of the expense, it does not follow that previous or underlying facts are to be disregarded as irrelevant. Indeed, in the *Banks* case Richardson J. explained that the purpose for which the taxpayer's property was originally acquired, as a private home, was a relevant factor, but not determinative in the circumstances of the case.[78]

As Richardson J. says later in his judgment, it "becomes a matter of degree, and so a question of fact, to determine whether there is a sufficient relationship between the expenditure and what it provided, or sought to provide, on the one hand, and the income-earning process, on the other".[79] In the *Banks* case, the taxpayer's use of a room in his house for income-earning purposes was "of sufficient . . . practical relevance"[80] to outweigh the fact that originally the mortgage debt had been incurred for private purposes. On the other hand, in the *A.G.C.* case, the origin of the bad debts written off by the company lay within an income-producing activity, and there was no subsequent factor that weighed against this element. Thus, it would seem that the bad debts in the *A.G.C.* case would satisfy the *Banks* test of deductibility, which examines the facts as at the time of the expenditure, bearing in mind that this test takes into account past as well as present facts. In *A.G.C. (Advances) Ltd.* v. *F.C.T.*, it was simply that the historical fact that the debts arose out of credit granted in the course of income-producing activities was the most significant element in the case.

Harley v. *C.I.R.*[81] fell between the *Banks* and *A.G.C.* cases. The taxpayer had borrowed money to buy rural land, and claimed to deduct the interest thereby

73 (1975) 132 C.L.R. 175.
74 (1937) 56 C.L.R. 290.
75 [1978] 2 N.Z.L.R. 472.
76 Ibid 477.
77 Idem.
78 Idem.
79 Ibid. 478.
80 Idem.
81 [1971] N.Z.L.R. 482.

incurred from his other income. In the year in question, the land was being used for farming, but, on the facts, the taxpayer's underlying purpose in buying the land was simply to hold it as an investment. Richmond J. held that the actual use to which the land was being put for the time being in any particular tax year was not the sole test of deductibility. Rather, the "real purpose" for which the asset was being employed had to be considered,[82] and the deduction was disallowed. *Harley* v. *C.I.R.* proceeded before the court on an all-or-nothing basis. Under the present form of section 104, the facts appear to disclose a suitable case for apportionment of the interest into deductible and non-deductible components.

XI. CAPITAL-SERVICING EXPENSES WHEN BUSINESS HAS CEASED

Where a business has ceased, but expenses continue to be incurred for the upkeep of its capital assets, the scale will often tilt the other way. In *Inglis* v. *F.C.T.*,[83] the taxpayer owned land which she and her husband farmed until 1969, when they became embroiled in some protracted litigation which took up all their energy. They stopped farming, but continued to pay rates and mortgage interest in respect of the land, and incurred expenses in travelling to the farm to keep it in order. The court disallowed these expenses as deductions for the years 1974 and 1975. The expenses were not "in gaining or producing assessable income". No income-earning activities were being carried out at the time of the expenditure. The pre-1969 farming activity was too remote in time. Although the taxpayer intended to resume farming in the future, this was insufficient, at least on the facts of the case, to render the expenditure income-related.[84] Fundamentally, the expenditure was to preserve a capital asset, and the relationship with the production of assessable income was too slight to be significant for tax purposes.[85] That the question is ultimately one of fact and degree is illustrated by comparing *Inglis* v. *F.C.T.* with *Queensland Meat Export Co. Ltd.* v. *Deputy F.C.T.*[86] There, the taxpayer closed down its meat works because of competition from a new abattoir. From 1931 to 1934 it kept the plant in working order, hoping business would improve. In 1934 it decided to sell, and incurred further maintenance expenses until 1936 when this plan was finally successful. It successfully claimed to deduct its outgoings between 1931 and 1936 in respect of watchmen's and engineers' wages, insurance and rates. Douglas J. held that so long as there was reasonable hope of using the plant in the future for income-earning activities, it was immaterial that no income was produced in any particular year. Moreover, maintenance expenses for a reasonable time after it has been decided to sell a factory are an incident of a business, and an outgoing in the gaining of income. As Lord Sumner has explained, "business is not confined to being busy; in many businesses long intervals of inactivity occur".[87] This case was decided on the earlier, stricter,

82 Ibid. 498.
83 (1971) 10 A.T.R. 493.
84 Ibid. 495, 496 per Brennan J.
85 Ibid. 503, per Davies J.
86 (1939) 1 A.I.T.R. 490.
87 *South Behar Rly. Co.* v. *I.R.C.* [1925] A.C. 476, 488.

Australian test. Consequently, the same result should be obtained on the basis of the current New Zealand and Australian legislation.

Following similar reasoning, one would expect a New Zealand court to hold that a taxpayer who leaves his rented business premises because they are no longer suitable can continue to deduct his rent until the end of the lease. This is the position in the United Kingdom.[88]

XII. PRELIMINARY EXPENSES

As explained above,[89] the general rule is that revenue expenses incurred in one year that are occasioned by the production of assessable income of a later year are deductible in the year when they are incurred. Is there an exception for preparatory expenses incurred before a business is commenced? Most of such expenditure is, of course, in respect of capital items such as premises and plant, and is clearly not deductible. But what of items of a revenue nature, such as rates on a factory building, and interest on money borrowed to pay for it?

Such expenditure is not deductible under section 104(b), because it is not "incurred in carrying on a business".[90] Interest is a special case, and appears not to be deductible at all. This is because, by section 106(1)(h), it qualifies for a deduction only where it is "payable on capital employed in the production of assessable income". Ex hypothesi, the capital concerned is not yet so employed. Like post-cessation expenses, start-up expenses must be deductible, if at all, under section 104(a).

It is sometimes argued on the basis of *Amalgamated Zinc (de Bavay's) Ltd.* v. *F.C.T.*[91] that start-up expenses are not deductible, because there is, as yet, no existing or continuing source of income. But this case must be re-examined in the light of *A.G.C. (Advances) Ltd.* v. *F.C.T.*[92] The better view is that the ordinary rule enunciated in *C.I.R.* v. *Banks*[93] applies. That is, it is a question of fact and degree as to whether expenses are deductible. Thus, for example, suppose a solicitor decides to set up on his own account, opening his office and commencing business on 1 April. During February and March he rents an office, buys stationery, and pays his annual practising fee.[94] It is thought that those expenses are deductible in the income year ending 31 March.[95]

On the other hand, it was held in *Softwood Pulp & Paper Ltd.* v. *F.C.T.*[96] that technical and economic studies and reports to investigate whether it is worthwhile setting up a business are not deductible. They are not occasioned by the

88 *I.R.C.* v. *Falkirk Iron Co. Ltd.* (1933) 17 T.C. 625; *Hyett* v. *Lennard* [1940] 2 K.B. 180.
89 See supra, section VIII.
90 Cf. *Inglis* v. *F.C.T.* (1979) 10 A.T.R. 493, 502, per Davies J. and see text accompanying n. 58, supra.
91 (1935) 54 C.L.R. 295.
92 (1975) 132 C.L.R. 175, discussed in text accompanying ns. 57 to 71.
93 [1978] 2 N.Z.L.R. 472, 478.
94 Contrast *Daley* v. *M.N.R.* [1950] C. Tax C. 254 (solicitor's admission fee not deductible).
95 Contra, Hansen "The Time of Commencement of a Business" (1974) 3 Aust. Tax Rev. 183; and see *C.I.R.* v. *Watson* [1960] N.Z.L.R. 259.
96 (1976) 7 A.T.R. 101.

carrying on of the business, but are in order to decide whether there should be a business at all. The ratio of the *Softwood Pulp* case is, perhaps, deceptively appealing. It should not be applied as a general rule. Many companies, as part of their ordinary operations, have research and development departments that are continuously engaged in investigating new products and techniques. Some mining companies are forever prospecting for new mines. Such regular expenses in the context of a large organization appear to be incidental to its ordinary income-earning processes, and therefore deductible. The rule in the *Softwood Pulp* case applies where the business does not yet exist, and the prospecting or research is to determine whether it should be commenced. In order to encourage research and prospecting, the Income Tax Act 1976 makes special provision for deductions in respect of these activities.[97] Where the taxpayer has committed himself to a business or other method of producing income, the better view is that expenses of a revenue nature are deductible, even though the actual income-earning process cannot yet be described as having started.[98]

If the analysis in the above paragraphs is wrong, and preliminary expenses are not deductible simply because they are preliminary to the production of income, the issue then arises as to when income-earning activity should be taken to start. There are three possible dates to consider:

(a) The date when the commitment to start the business is made;
(b) The date when current business operations in a reasonably substantial sense can be said to start (for example, in a business involving cultivation, the ground is cleared and planting is under way) and;
(c) The date when commercial production for sale begins (for example, in a similar case, when harvesting can start).

There is in the United Kingdom authority for both the second[99] and the third[100] of these. If anything, logic favours the third date, when the profit-making structure is in place, and income can start to be produced.[101]

Whether it is because he accepts that preliminary expenses are in fact deductible, or because he considers that the business should be regarded as commencing at an earlier time, it is understood that the Commissioner in practice allows the following establishment costs as deductible expenditure:

(a) The initial costs of advertising for, training, and employing staff before start-up;
(b) Wages of engineers and others engaged in testing machinery before start-up;
(c) The cost of materials consumed in testing;
(d) Rates and interest on a property as from the year in which it was first used or the year when building construction commenced.

97 Section 144 (research); s. 214 A(ff) (prospecting).
98 *Hanlon* v. *F.C.T.* (9181) 12 A.T.R. 540 (stud cattle leased as first step in establishing elite herd. Rent held deductible).
99 *Vallambrosa Rubber Co. Ltd.* v. *Farmer* 1910 S.C. 519, 526 per Lord Johnston.
100 *Birmingham & District Cattle By-Products Co. Ltd.* v. *I.R.C.* (1919) 12 T.C. 92.
101 Idem.