Deduction of revenue expenses

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In day to day working one of the most important provisions of the Income Tax Act 1976 is section 104. It is the section which authorises deduction of most expenses which may be incurred in winning assessable income. This article endeavours to analyse some of the vast body of case law which has developed under this and comparable foreign provisions. It also focuses on some key areas, exploring the possibility of difficulties with some of the jurisprudence.

I. INTRODUCTION

The Income Tax Act 1976 provides a code in relation to deductibility.[1] This is the effect of section 101, which prohibits the deduction of any expenditure or loss except as expressly provided for in the Act. Deductions permitted by the Act fall into three broad categories. There are those authorised by section 104 (the general authority for deducting expenses incurred in earning income) deductions authorised by provisions dealing with particular items of expenditure,[2] and deductions by way of allowance.[3] In this article attention will focus on section 104.

Section 104 is an induly condensed provision[4] with its brevity and importance standing in high contrast. In a mere eighty-four words it authorises the deduction of most business operating expenses. This is achieved by the creation of two limbs of deductibility, one for persons earning assessable income and one for only those carrying on a business.[5] The two limbs are not mutually exclusive[6] so a business taxpayer is entitled to rely on the first limb.[7] In actual working the two limbs

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1 *C.I.R.* v. *Banks* [1978] 2 N.Z.L.R. 472, 475. The code is not entirely exhaustive since there may be deduction of projected costs when calculating the annual profits or gains of a continuing land subdivision scheme: *Lowe* v. *C.I.R.* [1981] 1 N.Z.L.R. 326.

2 For example, provisions to stimulate economic activity (*C.I.R.* v. *International Importing Ltd.* [1972] N.Z.L.R. 1095, 1096) or to overcome an adverse court decision (c.f. s.139 and *Kemball* v. *C.T.* [1932] N.Z.L.R. 1305 and s.148 and *Grant* v. *C.T.* [1948] N.Z.L.R. 871).

3 This includes ordinary depreciation allowable under s.108 and the various allowances contained in ss.113-115.

4 *A.G.C. (Advances) Ltd.* v. *F.C.T.* (1975) 132 C.L.R. 175, 185.

5 *Europa Oil (N.Z.) Ltd.* v. *C.I.R. (No. 2)* (1974) 1 N.Z.T.C. 61,169, 61,205.

6 *John Fairfax and Sons Pty. Ltd.* v. *F.C.T.* (1959) 101 C.L.R. 30, 40.

7 *Grieve* v. *C.I.R.* [1984] 1 N.Z.L.R. 101, 104.

cover much the same ground[8] although there may be instances where the second limb permits deduction of a greater amount.[9]

The leading case on the interpretation of section 104 is *C.I.R.* v. *Banks*.[10] Almost as important is *Buckley & Young Ltd.* v. *C.I.R.*[11] In both cases the Court of Appeal identified two important features of section 104. First there must be a sufficient relationship between the expenditure or loss and the income earning process if the outgoing is to fall within the words of the section.[12] Second, the section contemplates apportionment: a deduction is allowed to the extent that the statutory standard of deductibility is met.[13] Discussion will be confined to an examination of statutory nexus, apportionment and, to the extent relevant, onus of proof. Together they cover entitlement to deductibility and the extent of that entitlement. Many of the problems which arise in the application of the section involve one or other of them.

II. GENERAL OBSERVATIONS ON DEDUCTIONS

To be incurred in gaining or producing the assessable income the outgoing must be incurred in the course of gaining or producing income looking to the scope of the operations or activities and the relevance thereto of the expenditure rather than the purpose in itself.[14] To justify deductibility the expenditure must show a relationship between the taxpayer concerned and the gaining or producing of his assessable income: a relationship with the taxpayer is not, in itself, enough.[15] The necessity for this relationship also means it is insufficient if the outgoing is incurred simply during the time the income is being earned.[16] Nor is it sufficient that it was proper and reasonable for the taxpayer to make the expenditure.[17] The outgoing need not be directly or immediately productive of profit.[18] Indeed it is a mistaken notion to assume that, unless it can be shown that the outgoing is profitable, it is not a legitimate deduction.[19] It becomes unnecessary therefore to trace the outgoing through to a receipt of income[20] although in some cases the quality of the outgoing may be determined in relation to the gaining of the income against which it is sought to be deducted.[21] Even if a tracing exercise was required a deduction

8 *Ronpibon Tin N.L.* v. *F.C.T.* (1949) 78 C.L.R. 47, 56. The High Court suggested that the second limb may have been introduced to make it clear a deduction is permitted for " . . . an expenditure directed not to obtain or increase revenue but to avoid or reduce expenditure in a business . . . ": ibid., 55.

9 For example, *Europa Oil (N.Z.) Ltd.* v. *C.I.R. (No. 2)* (1974) 1 N.Z.T.C. 61,169, 61,197 and 61,205 - 61,206.

10 [1978] 2 N.Z.L.R. 472.

11 [1978] 2 N.Z.L.R. 485.

12 [1978] 2 N.Z.L.R. 472, 476 and [1978] 2 N.Z.L.R. 485, 487.

13 Idem.

14 *C.I.R.* v. *Banks* [1978] 2 N.Z.L.R. 472, 478.

15 Ibid., 476.

16 *C.T.* v. *Webber* [1956] N.Z.L.R. 552, 559.

17 *F.C.T.* v. *Green* (1950) 81 C.L.R. 313, 317.

18 *Morgan* v. *Tate & Lyle Ltd.* (1952) 35 T.C. 367, 400.

19 *C.I.R.* v. *Falkirk Iron Co. Ltd.* (1933) 17 T.C. 625, 630-631.

20 *Toohey's Ltd.* v. *C.T.* (1922) 22 S.R. (N.S.W.) 432, 440.

21 *Cliffs International Inc.* v. *F.C.T.* (1979) 142 C.L.R. 140, 148.

might yet be available notwithstanding that the outgoing may produce a capital receipt.[22] The essential notion would appear to be that the outgoing should have been made on the grounds of commercial expediency at the least in order to facilitate indirectly the carrying on of the business: it need not be made of necessity and with a view to a direct and immediate benefit to the trade.[23] The income which the outgoing must help produce is the assessable income of the taxpayer generally without division into periods of account.[24] Deductibility does not necessarily turn on whether the outgoing is of a revenue character in the hands of the recipient.[25] In this matter the Commissioner is bound neither by the taxpayer's statement of account nor by the heading under which the expenditure is placed.[26] Although he is entitled to ascertain for what the expenditure was in reality incurred,[27] that reality is only in relation to the legal character of the payment and not its economic consequences.[28] It is not for the Court or the Commissioner to say how much a taxpayer ought to spend in obtaining his income but only how much he has spent. It must not be forgotten that this is not an area of law where it is possible to devise a judicial formula which, as a substitute for the statutory language, could be applied in all cases and, in the end, a decision in a particular case must be reached on the application of the statutory language to its particular circumstances.[29] In one case[30] the Court of Appeal took as the yardstick of deductibility the extent to which the asset giving rise to the expenses was used in the production of income. This approach is worthy of closer analysis.

III. SPECIFIC PROBLEMS CONCERNING DEDUCTIONS

A. Degree of Asset Use

The taxpayer in *de Pelichet McLeod and Co. Ltd.* v. *C.I.R.*[31] carried on the business of merchant and stock and station agent. For the 1965-1968 income years it claimed a deduction for the rates, land tax and rents incurred in relation to three properties, one in Taupo, one in Napier and one in Hastings. The quarter acre property in Taupo was used as a customer car park and the seven acre block in Napier was used to grow one crop of barley and occasionally hold stock overnight between stock sales. The three acre property at Hastings was partly rented

22 For example, a lessor was allowed a deduction for fire insurance premiums paid on its leased premises (*Usher's Wiltshire Brewery Ltd.* v. *Bruce* (1914) 6 T.C. 339) on the footing that they were made to safeguard earning capacity and protect the trade from loss (*Morgan* v. *Tate & Lyle Ltd.* (1952) 35 T.C. 367, 400).

23 *Atherton* v. *British Insulated and Helsby Sables Ltd.* (1926) 10 T.C. 155, 191.

24 *Ronpibon Tin N.L.* v. *F.C.T.* (1949) 78 C.L.R. 47, 56.

25 *Ralli Estates Ltd.* v. *C.I.T.* [1961] 1 W.L.R. 329, 335 and *Coalville Urban District Council* v. *Boyce* (1934) 18 T.C. 655, 689.

26 *C.I.R.* v. *Europa Oil (N.Z.) Ltd.* [1971] N.Z.L.R. 641, 648.

27 Idem.

28 *Europa Oil (N.Z) Ltd.* v. *C.I.R. (No. 2)* [1976] 1 N.Z.L.R. 546, 553.

29 *C.I.R.* v. *Banks* [1978] 2 N.Z.L.R. 472, 477.

30 *C.I.R.* v. *Europa Oil (N.Z.) Ltd.* [1971] N.Z.L.R. 641, 649. It is difficult to give a clear meaning to the dictum since the qualification seems to negate the promotion. Further, in apportioning an outgoing the Commissioner may, in effect, be saying how much a taxpayer ought to spend.

31 (1982) 5 N.Z.T.C. 61, 216.

out at a nominal rent and partly used to store posts and battens for the produce department. In each case the respective actuating intention was to acquire land for a shop, a wool store and seed and grain stores but the properties were sold before these intentions were realised.

Only the outgoings in relation to the Taupo property were a deductible item. There was a continuing employment of the property as part of the current operations of the taxpayer's business in Taupo.[32] The evidence did not warrant the drawing of a like inference in relation to the other two properties. There was not a sufficiently substantial use of the Napier property in conjunction with the stock and station business to justify the inference that the property had been committed to the taxpayer's continuing trading operations.[33] The proved use of the Hastings land was altogether too insubstantial to serve as the basis for a finding that it was employed in the taxpayer's trading operations.[34]

In analysing the problem the Court of Appeal focussed on the extent of business use of the land. There are three difficulties with this sort of approach. These are whether it is necessary that there should be any such use, determining the necessary degree of use, and whether the use must be of a kind relating to current business operations.

First, it is not difficult to envisage situations in which, for sound business reasons, the asset is not actually used, or wholly used, in the production of assessable income. An asset may be held in reserve until a propitious time for committal or recommittal to income earning operations. Plant might be mothballed for example during a time of financial stringency. There is some authority for the view that deductibility would be allowed during any such hiatus.[35]

Second, there was no elaboration on what degree of use of the asset, in income earning activities, is adequate to establish deductibility, the Court remarking only that there was not "substantial"[36] use in the present case. It is not difficult to discover cases which compare unfavourably with each other on the basis of this approach. For example, the occasional use of the land in *de Pelichet* was not adequate while use of a dining room as a work study for a mere 280 hours out of the year's 8,760 hours was enough to confer deductibility.[37] Nor is it difficult to conceive of cases where deductibility will be allowed notwithstanding little business use. For example, the firm of accountants in *Hillman* v. *F.C.T.*[38] was allowed a deduction for the rent of a suite of offices which it maintained for use by two retired partners. They attended to their own concerns in the offices on the understanding they would be available for on-the-spot consultations. Deductibility was

32 Ibid. 61, 220.
33 Ibid. 61, 221.
34 Idem.
35 *Queensland Meat Export Co. Ltd.* v. *F.C.T.* [1939] St.R.Qd. and *Hunter* v. *C.T.* [1937] N.Z.L.R. 204.
36 (1982) 5 N.Z.T.C. 61, 216, 61, 221.
37 *C.I.R.* v. *Banks* [1978] 2 N.Z.L.R. 472, 474. Cf. *Handley* v. *F.C.T.* (1981) 148 C.L.R. 182, where a barrister was unable to deduct expenses relating to a study in his home which he used for 900 hours per annum for work purposes.
38 69 A.T.C. 4112.

permitted even though use of the premises in the partnership business can have been only slight.

Third, there have been cases where deductibility has been upheld in the absence of any such relationship between asset use and ordinary business operations. *C.I.R.* v. *Falkirk Iron Co. Ltd.*,[39] for example, concerned a claim by a foundry company to deduct the loss suffered when it had to sublet warehouse premises which could no longer be gainfully employed for storage purposes. The Court of Session allowed the deduction on the basis that since the rent for the premises had originally been deductible it remained so notwithstanding that the premises were no longer profitably employed in the business.[40] The Lord President expressly rejected the Crown's contention that deductibility was not available because the loss was not incurred in the taxpayer's trade of an iron foundry business.[41]

On the basis of these three factors it can be argued that degree of asset use presents an unsatisfactory touchstone of deductibility. It overlooks problems associated with assets temporarily held in reserve until a time more convenient for application in income earning operations. Another problem area is expenses associated with termination of a business.

B. Termination of Business

It is established that no deduction is available for an outgoing made to go out of business.[42] However, deductibility is permitted for a payment made to achieve orderly conduct of the business prior to closure.[43] The problem is to distinguish between each class of case. The difficulties in doing so are illustrated by *F.C.T.* v. *Foxwood (Tolga) Pty. Ltd.*[44]

Foxwood (Tolga) concerned a company which sold its business undertaking, the contract providing that the taxpayer should pay amounts representing the accrued entitlements of its employees for long service leave and holiday pay. The payment for holiday pay was deductible because from a practical, although not from a legal, point of view the payment discharged the obligation of the taxpayer to its employees.[45] The position with regard to long service leave was different because the taxpayer was not liable, and never could become liable, to pay anything in respect of long service leave. It was impossible to say that the object of the payment was to discharge a liability which did not and never could exist. It was a contribution to assist the purchaser to discharge obligations which could be

39 (1933) 17 T.C. 625.

40 This reasoning is not applicable in New Zealand, where the outgoing must be judged at the time it is incurred and not when the property was initially acquired: *C.I.R.* v. *Banks* [1978] 2 N.Z.L.R. 472, 477.

41 (1933) 17 T.C. 625, 630. This was a strong argument as the outgoing had to be for the purposes of the taxpayer's trade and, on a strict view, a rental loss could hardly be part of an iron foundry trade. See also *Hyett* v. *Lennard* (1940) 23 T.C. 346.

42 *Peyton* v. *F.C.T.* (1963) 109 C.L.R. 315, *Parklan Pty. Ltd. (in liq.)* v. *F.C.T.* (1983) 67 F.L.R. 328 and *C.I.R.* v. *Anglo Brewing Co. Ltd.* (1925) 12 T.C. 803.

43 *O'Keefe* v. *Southport Printers Ltd.* [1984] B.T.C. 205.

44 (1981) 147 C.L.R. 278.

45 Ibid., 286.

expected to bind him in the future and, as such, it was incidental and relevant to the sale of the business.[46]

It can be argued the High Court should have reached a conclusion favouring deductibility in relation to the payment for long service leave. No doubt the taxpayer's object with respect to each payment was the same, viz, to contribute to the leave entitlements that were attributable to service with the taxpayer and which would crystallise in the future. The long service leave payment could have been deductible as a voluntary donation to those maturing entitlements on the footing that the taxpayer bore some moral, though not legal, responsibility for their satisfaction. Furthermore, it is unreasonable to analyse the problem in terms of whether the taxpayer actually was liable in respect of long service leave. Deductibility is influenced by object and not whether the taxpayer was correct at law in assuming that the payment would discharge a legal liability.[47]

On the basis of these two points it is reasonable to take the view that the High Court did not make a satisfactory analysis of the problem. Another area which can be described in similar terms is that involving outgoings conferring a benefit on another party.

C. Outgoings for the Benefit of Another Party

In some decisions the outgoing has been viewed as having been made for the benefit of another party. Since it did not relate to production of the taxpayer's assessable income the claim failed. This feature is always present to some degree at least. What is to be considered at this point is whether it is sufficient to defeat the entire claim. The authorities go either way.

Early authority favoured the view that benefit to another party should be regarded as inherent in the outgoing and normally not material. *Usher's Wiltshire Brewery Ltd.* v. *Bruce*[48] concerned a brewer who also owned several licensed premises. These were leased out in return for a trade tie. Each lease made the tenant responsible for affecting repairs to the premises but the taxpayer found it desirable to bear the cost " . . . not as a matter of charity but of commercial expediency . . . in order to avoid the loss of tenants. . . . "[49] The taxpayer claimed to deduct the cost of repairs and other outgoings relating to the premises but the Crown disallowed the claims, relying on *Brickwood and Co. Ltd.* v. *Reynolds*.[50] There the Court of Appeal had held that another brewer could not deduct the cost of repairs made to its tied houses. The claim had failed on the ground that because the outgoings also benefited the publican's trade it was not a case of money wholly and exclusively laid out for the purpose of the brewer's trade.[51] The House of

46 Ibid., 286-287.
47 At least under the purpose test of deductibility it does not matter if the taxpayer's purpose is misconceived: *Morgan* v. *Tate & Lyle Ltd.* (1954) 35 T.C. 367, 417.
48 (1914) 6 T.C. 399.
49 Ibid., 403; the finding of the Commissioners.
50 (1897) 3 T.C. 600; followed in *C.T.* v. *Ballinger & Co. Ltd.* (1903) 23 N.Z.L.R. 188, a case not followed in *C.I.R.* v. *Murray Equipment Ltd.* [1966] N.Z.L.R. 360.
51 Ibid., 608 and 610.

Lords rejected this reasoning. The money was laid out as a necessary incident of the profitable working of the brewery business and it was deductible notwithstanding that it enured for the benefit of the separate trade in the tied house.[52]

Usher suggests the proposition that the proper approach is to analyse deductibility problems from the perspective of the taxpayer who incurs the outgoing. Entitlement to deductibility is not lost simply because there is benefit to another trade when accomplishing the advantage sought for the taxpayer's own trade. There are two decisions which are not reconcilable with this proposition. One is an English case concerning deductibility of expenses incurred for the benefit of a subsidiary and the other is a New Zealand case involving partnership outgoings for the benefit of another partnership grouping to which the partners belonged.

Marshall Richards Machine Co. Ltd. v. *Jewitt*[53] concerned a company which incorporated a subsidiary in the United States to act as a selling and distribution agent for its products. The taxpayer agreed to make annual payments of $25,000 to cover operating expenses of the subsidiary and it claimed a deduction for these payments. The claim was rejected. Upjohn J. found that this was not a case of payments laid out to advance the trade of the taxpayer but one of payments made to enable the subsidiary to meet its obligations and continue in existence.[54] He also held the payments to be of a capital nature since they had been made to finance the subsidiary company.[55]

The decision can be compared with the similar case of *Robinson* v. *Scott Bader Co. Ltd.*[56] The taxpayer had a wholly owned subsidiary in France through which it supplied a French and other European customers. The subsidiary fell into financial difficulty and the taxpayer decided to mount a rescue operation. The object of the operation was to further the taxpayer's business in France and in Europe.[57] One of its employees was seconded to act as manager of the subsidiary and the taxpayer claimed to deduct the remuneration paid to him when so acting. The Court of Appeal allowed the claim. The real purpose of the outgoing was to further the taxpayer's business in Europe with improvement to the subsidiary's financial position being an inevitable result.[58] Nor was the payment one of capital: "[i]t was being expended for the purposes of the trading of the company and could not be described as capital."[59]

Marshall Richards and *Scott Bader* share the common theme of deductibility of the cost of assistance given by a parent company to a subsidiary. In each case the ultimate object was promotion of the parent's own business in another country through that indirect means. The different results might be supported on the

52 (1914) 6 T.C. 399, 419.
53 (1956) 36 T.C. 511.
54 Ibid., 526.
55 Idem.
56 (1981) 54 T.C. 757.
57 Ibid., 770, the finding of the Commissioners.
58 Ibid., 772.
59 Idem.

ground that in each case the Commissioners had made a finding of fact as to object and with that finding the Court could not interfere.[60] It is apparent, however, that in *Scott Bader* a broader view was taken as to what a company may do, without negating deductibility, to promote its own trade. The Court of Appeal must have accepted that that may be accomplished by means of promoting the trade of the subsidiary. The Court, in other words, was prepared to look beyond promotion of the subsidiary's business. That latter aspect appears to have assumed the quality of merely an inevitable effect inherent in attaining the larger object. In this respect the decision is consistent with the reasoning applied in *Usher*. If this analysis is correct the decision in *Marshall Richards* is at least questionable. There was no canvassing of the alternative view that benefit to the subsidiary was simply the result or effect of the object of furthering the taxpayer's business in the United States.

Failure to consider alternative possibilities is also a criticism which can be made of *Harley and Jenkins* v. *C.I.R.*[61] Briefly the facts were that a partnership of two combined with another partnership of two to carry on cattle grazing activities on a 40 acre block. The land was owned partly by the first partnership and partly by the combined partnership. Each partnership made available, free of charge, its own block of land for use by the composite partnership. Each partnership of two claimed to deduct the loss suffered on account of the servicing costs each incurred in making the land it owned available for use by the composite partnership. The claims were rejected. North P. and Turner J. put their decision on the ground that the expenses had been incurred not in producing income for the party which claimed the deduction, the partnership of two, but in producing income for another party, the partnership of four. The partnership of two cannot deduct expenses incurred in earning income for the partnership of four.[62]

Other reasons were also given. Turner J. took the point that in one income year the outgoings produced no income but a loss. A deduction is permitted for expenditure incurred in the production of assessable income and since none had been produced " . . . there was no assessable income in the production of which these expenditures could be said to have been incurred."[63] Richmond J. said it was impossible to say that the expenditure as a whole was exclusively incurred in the production of assessable income. The main purpose was the acquisition and retention of the land as an investment with some sensible, although minor, use of the land pending realisation.[64] Since the taxpayers' claim had been presented on an all or nothing basis it was unnecessary to consider whether there ought to have been an apportionment.[65]

60 The limited nature of appellate jurisdiction on questions of fact is laid down in *Edwards* v *Bairstow & Harrison* (1955) 36 T.C. 207, 229.
61 [1971] N.Z.L.R. 482.
62 Ibid., 489 and 493.
63 Idem. This is curious reasoning in the light of the nature of each claim. It was on the basis of a net loss suffered in a farming business so the claim was for a loss — and not expenditures — incurred in the production of assessable income.
64 Ibid., 497. Essentially the view also of the court below: (1969) 1 A.T.R 27, 30
65 Idem.

It was unfortunate the reason relied upon by Richmond J. was not considered in more detail. By no means is it certain that intention to sell a farm property vitiates entitlement to deductibility of farm expenses. In *Tweedle* v. *F.C.T.*,[66] for example, it was held that since a business was being carried on farm outgoings were deductible notwithstanding a settled intention to sell the property at an opportune time.[67] More thought ought to have been given to the circumstances in which farm operating expenses cease to be deductible when there is an intention to sell the property.

The second reason relied upon by Turner J. is entirely unsatisfactory. The opposing view is that the notion of statutory nexus should be applied, at the time the outgoing is incurred, to determine deductibility and the conclusion arrived at ought not to be disturbed should it be later ascertained that the year's trading activities disclose a loss situation. There is, moreover, adequate authority for the view that outgoings need not produce income.[68]

The reason relied upon by both North P. and Turner J. is not compelling. It can be argued that the outgoings of each land-owning partnership were incurred in gaining or producing income for that partnership because, by providing the land and incurring the outgoings, income would be earned by the composite partnership and, in due course, be available for distribution to members upon a division of profit. It was in this broad sense of generating income from another source that the outgoings of each partnership were incurred in producing income for that partnership.[69] Income is assessed on a global and not a source basis.[70] One implication is that a deduction is permitted for an outgoing which produces income from another source.[71]

Inevitably *Harley* invites comparison with *Usher*. In each case a property owner claimed deductions for outgoings relating to property used in the business of the occupier. Benefit to the taxpayer in *Usher* was in the form of retaining a captive market through the trade tie, while in *Harley* it was the income to be received upon a division of profit. In *Usher* the House of Lords was firmly of the view that deductibility of the outgoings obtaining the advantage was not lost merely because there was incidental benefit to the trade of the occupant. The facts in *Harley* show no good reason why the same view could not have been taken in that case.

66 (1942) 7 ATD 186.

67 Ibid., 189. Similarly, in *Land Projects Ltd.* v. *C.I.R.* [1964] N.Z.L.R. 723, a subdivider who purchased a farm business as a going concern and operated it for nine days pending sale was held to be carrying on a business for that nine day period. The proceeds of sale from the trading stock were assessable.

68 See n.19 supra and *Hughes* v. *Bank of New Zealand* (1938) 21 T.C. 472, 524.

69 Certain remarks of Richmond J suggest his Honour would have agreed with this proposition: [1971] N.Z.L.R. 482, 497.

70 *North Island Wholesale Groceries Ltd.* v. *Hewin* (1982) 6 N.Z.T.C. 61, 289, 61, 294.

71 *Ure* v. *F.C.T.* (1981) 50 F.L.R. 219, 230; where the example was given of interest paid on borrowed funds used to buy shares which generate dividend income. By reason of s.63 this example could not apply to a company.

What requires to be considered next is the class of case where the element of benefit to another party, and other non-income producing benefits, operate to defeat part of the claim. This involves examination of the principles relating to determining character of the outgoing and the power of apportionment.

D. Character of the Outgoing

In determining a question of statutory nexus 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. This, in turn, requires determining the true character of the payment.[72] Character can be determined only from the circumstances surrounding the outgoing: a bare payment of money is itself devoid of any character.[73] Of those surrounding circumstances one of the most difficult aspects is the assessment of what, if any, weight is to be given to indirect objects the taxpayer had in mind in incurring the outgoing.[74] It is unfortunate but no rigid principle can be applied in determining what, if any, weight should be given to indirect objects of that nature.[75] There are, however, some principles which assist in determining whether indirect objects should be taken into account. Before referring to them four broad propositions can be cited.

First, an ancillary or incidental advantage sought by the outgoing will not affect the character of the outgoing.[76] It can be disregarded on the basis of the principle of de minimis.[77]

Second, the cost of implementing a decision on a business matter may be deductible even though it may have been influenced by considerations not wholly of a commercial character.[78] An example is the case of a company which paid the legal costs of directors who were prosecuted for the business methods they employed in carrying on the company's business. The revenue character of the payment was not lost simply because it was apt to serve both the business purpose of protecting the company's trading position and the purpose of protecting the personal interests of the directors.[79]

Third, where the object of the expenditure is business promotion, it is not disqualified merely because attainment of some other objective is necessarily inherent in the act.[80] An example is provided by the case of a company contributing to an employee share purchase scheme. The contributions were of a revenue character

72 *Buckley & Young Ltd.* v. *C.I.R.* [1978] 2 N.Z.L.R. 485, 487.
73 *Cliffs International Inc.* v. *F.C.T.* (1979) 142 C.L.R. 140, 162.
74 *Ure* v. *F.C.T.* (1981) 50 F.L.R. 219, 233.
75 Idem.
76 *Buckley & Young Ltd.* v. *C.I.R.* [1978] 2 N.Z.L.R. 485, 489.
77 *C.I.R.* v. *Carron Co.* (1968) 45 T.C. 18,67.
78 *Heather v. P.E. Consulting Group Ltd.* (1972) 48 T.C. 293, 318; where the example was given of use of a car in preference to a train on a business journey because the taxpayer, even today, enjoys motoring.
79 *Magna Alloys and Research Pty. Ltd.* v. *F.C.T.* (1980) 49 F.L.R. 183, 198.
80 *Bentleys, Stokes & Lowless* v. *Beeson* (1952) 33 T.C. 491, 504; where the example was given of a solicitor who entertains a client: the purpose of hospitality is unavoidably involved in the activity itself.

even though one of the objects of the scheme was the capital advantage of removing the prospect of outside interference with the business of the company.[81]

Fourth, when determining character of an outgoing, a distinction may be drawn between the object of an expenditure and its effect. An expenditure made exclusively to serve the purposes of the business remains deductible even though an unavoidable effect is to produce private advantage.[82] An example is the case of outlays for the maintenance of a farm house: private benefit to the occupants may be merely a by-product.[83] Again there are no guiding principles which show how to make the distinction. It is a difficult distinction to draw. Where the result of the expenditure is known at the time it is made how is it to be determined whether attainment of that result is a deliberate object or merely a foreseen consequence?

There are further principles which show that not all benefits sought by an outgoing are taken into account in determining character. These have developed in apportionment cases, where the Commissioner has exercised the power to apportion and has excluded the value of that part of the outgoing unrelated to production of the taxpayer's assessable income.

E. Collateral Benefits and Apportionment

The issue of apportioning an outgoing to exclude the value of non-income producing benefits has arisen in the context of the purchase of trading stock ostensibly at an inflated price. The Commissioner reduced the deduction for the purchases to exclude an amount equal to the excess. He acted on the view that that component was not related to production of the taxpayer's income. The High Court of Australia rejected his view and held the outgoing to be deductible in full. The reason given was that the Commissioner may not dictate the level of the taxpayer's outgoings.[83a] The Privy Council came to the same conclusion but for a different reason. This was that the non-income producing benefit was not enforceable through the legal rights acquired by the outgoing.

The taxpayer in *Europa Oil (N.Z.) Ltd.* v. *C.I.R. (No. 2)*[84] carried on business distributing petroleum products in New Zealand. These were purchased from Europa Refining Co. Ltd. ("Europa Refining"), a member of the same corporate group. In turn Europa Refining purchased its supplies from a subsidiary of the Gulf Oil Corporation ("the Gulf group"). The profit of five cents per gallon made on the refining of these purchases was shared equally between a member of the Gulf group and Associated Motorists Petrol Co. Ltd. ("AMP"), a wholly owned subsidiary of the taxpayer. The Commissioner considered that each payment for petroleum products was partly for the share of the refining profit received by

81 *Heather v. P.E. Consulting Group Ltd.* (1972) 48 T.C. 293, 321- 322.
82 *Mallalieu* v. *Drummond* [1983] 2 A.C. 861, 870, where the example was given of a doctor who spends a week on the Riviera attending a patient/friend; an unavoidable effect being a week's stay on the Riviera. See also *Tucker* v. *Granada Motorway Services Ltd.* (1979) 53 T.C. 92, 105.
83 *Korner* v. *C.I.R.* (1969) 45 T.C. 287, 300.
83a *Cecil Bros. Pty. Ltd.* v. *F.C.T.* (1964) 111 C.L.R. 430.
84 [1976] 1 N.Z.L.R. 546 (PC).

AMP. He reduced the taxpayer's deduction for the purchases of trading stock[85] accordingly.[86] The Privy Council held that the deduction was not capable of an apportionment. There could be no doubt the outgoing would have been deductible in full if the contract with Europa Refining had stood alone. But it formed part of a complex of interrelated contracts. The question became whether the legal effect of the interrelated contracts was such that upon acceptance by the taxpayer of the obligation to pay the purchase price for the goods ordered:[87]

> the taxpayer company by the performance of that obligation acquires a legally enforceable right not only to delivery of the goods but also to have some other act performed which confers a benefit in money or in money's worth upon the taxpayer company or some other beneficiary.

Only if the answer was yes could the outgoing be apportioned to exclude the expenditure incurred in obtaining performance of the other act. In their Lordships' view the taxpayer did not have a legal right to performance of that other benefit. The only right it acquired which was legally enforceable against anyone was the right to delivery of the feedstocks by Europa Refining. It followed that the true legal character of the whole of the expenditure was that of the purchase of trading stock and, as such, it was deductible in full.[88]

The gravest question concerning the Board's decision is the width of application of the test of legal rights. On this point their Lordships made no comment. The High Court of Australia raised the question in a case where the Court found it unnecessary to express a concluded view. The High Court did, at least, identify one area where the test cannot apply. At the same time the High Court stated another principle restricting the power of apportionment.

The taxpayer in *F.C.T.* v. *South Australian Battery Makers Pty. Ltd.*[89] was the lessee of premises and a sister subsidiary, Property Options Pty. Ltd. ("Property Options)", held an option to purchase them. Should the option be exercised a pre-determined portion of the rent paid by the taxpayer was to be applied in reduction of the purchase price. By a 3-2 majority the High Court held that the outgoings for rent could not be apportioned even though the Court recognised that they were made with the purpose that part might be treated as a portion of the price of a capital asset which Property Options probably would acquire.[90] The majority view was that the extent of deductibility was to be determined by the advantage the expenditure intended to gain, directly or indirectly, for the taxpayer and it was not permissible to consider an advantage gained by another where the

85 The Court of Appeal made it clear only the outgoings for trading stock were capable of apportionment. Other outgoings for freight, insurance and harbour improvement levies did not have "the necessary close link" with the refining profit: (1974) 1 N.Z.T.C. 61, 169, 61, 204.
86 The Court of Appeal was critical of this approach. McCarthy P remarked it " . . . is not based on any principle that I can understand": (1974) 1 N.Z.T.C. 61, 169, 61, 195.
87 [1976] 1 N.Z.L.R. 546, 553.
88 Ibid., 555.
89 (1978) 140 C.L.R. 645.
90 Ibid., 656.

taxpayer neither shares in it nor can secure its enforcement.[91] The only advantage the taxpayer sought or gained by making the payments was that which it obtained as lessee under the lease. There was nothing to suggest the taxpayer could or would share in the advantage Property Options would derive from the making of the payments, and the taxpayer had no legal right to ensure that Property Options did secure its rights under the option.[92]

There is another important case to which reference also should be made. This is the decision of the Federal Court in *Ure* v. *F.C.T.*[93] The taxpayer in *Ure* was a solicitor who borrowed funds at rates of interest of up to 12.5 per cent only to on-lend them to his wife and a family company at a rate of 1 per cent. The funds were again on-lent to another family company, the trustee of the taxpayer's family trust, which applied the funds to the purchase of a family residence and to make interest-bearing deposits. The taxpayer's claim to deduct the interest paid of $8156 was reduced to $660, being the amount of interest received, on the footing that the interest was paid not only to produce the interest received but also to obtain accommodation, benefit his wife and family trust and reduce his taxable income. The Federal Court saw no reason for interfering with that approach. The predominant, though indirect, objects of the outlays of interest were not concerned with the earning of income but were of a private or domestic nature.[96]

Four comments can be made about these three cases. The first relates to the High Court's view that no cognisance should be taken of a benefit conferred on another where the taxpayer can neither share nor enforce it. This is in conflict with *Europa (No. 2)*. There the Privy Council said an apportionment may be made where the extraneous benefit is conferred upon " . . . the taxpayer company or some other beneficiary."[95] Clearly their Lordships did not envisage it was imperative that the collateral benefit should be conferred upon the taxpayer.[96]

The second comment relates to the question whether the legal rights test is a practical one. That it may not be is indicated by a comparison of two of the cases. In *Europa (No. 2)* the collateral benefit, the refining profit, arose outside of the relationship which conferred legal rights, viz, the relationship of buyer and seller of petroleum products. The same situation obtained in *Ure*. The taxpayer secured legal rights only in those transactions to which he was a party as borrower or lender. The collateral benefits were generated through a chain of subsequent loan arrangements. The Privy Council was emphatic there could be no recognition of benefits originating outside of the relationship conferring legal rights. The

91 Ibid., 660. Stephen and Aicken JJ concurred.
92 Idem.
93 (1981) 50 F.L.R. 219.
94 Ibid., 223. *F.C.T.* v. *Phillips* 78 A.T.C. 4361 represents the converse class of case, where the non-income producing benefits were found to be merely an inducement for, and not a purpose of, the outgoing.
95 [1976] 1 N.Z.L.R. 546, 553.
96 In the *Europa Oil* cases the benefit indirectly would be so conferred since the refining profit would come back by way of a dividend from AMP, a wholly owned subsidiary.

Federal Court proceeded on the assumption that absence of legal rights securing performance of the collateral benefits was no barrier to taking cognisance of them. As well as showing an inconsistency this comparison also indicates that the test of legal rights is not a practical one. It would not have been a sensible solution of the problem considered in *Ure* to ignore the personal benefits forming the principal reason for the outgoing simply because their attainment was not secured by the legal rights conferred by the outgoing. It is reasonable to make a similar remark in relation to *Europa (No. 2)*. Realisation of the refining profit was an advantage deliberately sought by each outgoing. To ignore it because it was not legally enforceable would be an unwise approach since it would lead to exclusion of benefits deliberately included in the bargain made by the taxpayer.

The third comment concerns the question of voluntary outgoings. This was raised by the High Court in *Battery Makers*. Gibbs A.C.J. pointed out that in many cases a deduction has been allowed for a voluntary outgoing notwithstanding that the taxpayer obtained no legally enforceable rights in return.[97] Their Lordships could not have meant, the Acting Chief Justice said, that in every case the character of an outgoing must be determined by having regard only to the contractual or other legal rights the taxpayer acquired in return for it. The Privy Council therefore can be criticised for overlooking the case of voluntary outgoings.

The final point is the issue of the range of circumstances in which an outgoing is to be analysed according to the legal rights it confers. Neither their Lordships nor the High Court made any observations on this point. The only guidance is provided by *F.C.T.* v. *Phillips*.[98] There the Federal Court rejected a contention by the Commissioner that *Cecil Bros. Pty. Ltd.* v. *F.C.T.*[99] and the *Europa Oil* cases should be confined to their own special facts, viz, expenditure laid out for the acquisition of stock in trade.[100] In the absence of authority the scope of the notion of legal rights becomes a matter of conjecture. One possibility is that its application is confined to the sort of situation considered in *Europa (No. 2)*, viz, where the impugned outgoing is made pursuant to a contractual arrangement. This would leave the way clear to analyse a voluntary outgoing on the basis of other principles. *Battery Makers* conforms with this view. In a case involving a lease the High Court was influenced by the aspect of legal rights. It was material because the taxpayer's inability to enforce attainment of the collateral benefit was a significant factor weighing against apportionment.[101] The decision therefore is at least compatible with the view that the notion of legal rights applies where the outgoing is made pursuant to a contractual arrangement.

Not all cases are consistent with this approach. For example, in one case the House of Lords permitted a lessor to deduct an outgoing which the lease made the contractual responsibility of the lessee.[102] In another the High Court of

97 (1978) 140 C.L.R. 645, 659.
98 78 A.T.C. 4361.
99 (1964) 111 C.L.R. 430.
100 78 A.T.C. 4361, 4370.
101 (1978) 140 C.L.R. 645, 660.
102 *Usher's Wiltshire Brewery Ltd.* v. *Bruce* (1914) 6 T.C. 399.

Australia allowed a deduction for a contractual payment even though it effected only a practical, and not a legal, discharge of an obligation owed by the taxpayer.[103] A reasonable view is that it is unknown the range of circumstances in which it will be appropriate to apply the notion of legal rights enunciated by the Privy Council in *Europa (No. 2)*.

In conclusion it can be said that the significance to be attached to collateral benefits obtained through an outgoing ranks as one of the most important and difficult issue of deductibility under section 104. It is an aspect which affects character and, in turn, apportionment. Its difficult nature is illustrated by the wide divergence of approach taken in these three cases. In *Europa (No. 2)* the outgoings for trading stock could not be apportioned because realisation of the refining profit was not secured by the legal rights acquired through the outgoing. In *Battery Makers* the capital benefit partially sought by the outgoing could not be apportioned for the reason that it was to be enjoyed by another party and the taxpayer could neither share nor enforce that enjoyment. In *Ure* apportionment was possible because attainment of the private and personal benefits formed part of the purposes of the outgoing. It is unfortunate this crucial problem should generate such a variety of answers.

F. Onus of Proof in an Apportionment Case

Once it has been determined that non-income producing benefits are to be excluded by an apportionment, the object becomes to ascertain how much of the outgoing is attributable to the deductible item.[104] The object is to produce a fair and reasonable assessment[105] or one which is fair and not arbitrary.[106] This may not be easy since the various benefits often will be incapable of accurate measurement. But difficulty is no reason for failing to make an apportionment upon evidence offered in support of it.[107] In this matter the onus of proof is largely but not, it seems, entirely with the taxpayer.[108]

The nature of the onus of proof in an apportionment case has been described in the following terms:[109]

> . . . the onus of proof must be applied in a broad and commonsense way. So that in such an apportionment case as the present the taxpayer must be able to point to some intelligible basis upon which a positive finding can be made that a defined part of the total sum is deductible. Where the Commissioner has refused a deduction and his assessment is challenged, then the taxpayer must establish that the decision is wrong and the extent to which the assessment should be varied. That last matter does not require an answer of absolute precision or one that has been calculated by some kind of scientific process but, unless the taxpayer can demonstrate affirmatively that at least a

103 *F.C.T.* v. *Foxwood (Tolga) Pty. Ltd.* (1981) 147 C.L.R. 278.
104 *Buckley & Young Ltd.* v. *C.I.R.* [1978] 2 N.Z.L.R. 485, 497.
105 *Europa Oil (N.Z.) Ltd.* v. *C.I.R. (No. 2)* (1974) 1 N.Z.T.C. 61,169, 61,195 and *Ronpibon Tin N.L.* v. *F.C.T.* (1949) 78 C.L.R. 47, 59.
106 *Buckley & Young Ltd.* v. *C.I.R.* [1978] 2 N.Z.L.R. 485, 498.
107 Ibid., 499.
108 Inland Revenue Department Act 1974, s. 36 places the onus of proof in objection proceeding with the taxpayer.
109 *Buckley & Young Ltd.* v. *C.I.R.* [1978] 2 N.Z.L.R. 485, 499.

minimum quantifiable sum is deductible, he will have failed to discharge the onus that for good practical reasons has been placed upon him by the legislature.

The responsibility to establish the deductible minimum should not impose an onus which is too exacting in all but the plainest case. An apportionment necessarily involves the exercise of judgment and some degree of estimation,[110] and where an estimate is necessary "[i]t is a question of fact and of figures whether what is proposed in each case is fair both to the Crown and to the subject."[111] In this class of case a fair balance must be maintained.[112] Very often a rough and ready process is involved[113] so the answer need not be one of absolute mathematical precision.[114] The remarks made in *Buckley & Young* warrant two further comments.

First, they do not allude to the possibility of any onus being placed with the Commissioner. In this regard they overlook what the Court previously had said in *Europa Oil (N.Z.) Ltd.* v. *C.I.R. (No. 2)*,[115] where certain remarks of the Privy Council in *C.I.R.* v. *Europa Oil (N.Z.) Ltd.*[116] were interpreted to mean that in an apportionment case " . . . the Commissioner must show that segregation and quantification is possible" notwithstanding that the general onus of proof is with the taxpayer.[117] By placing an onus on the Commissioner the Privy Council's remarks are not consistent with the statutory allocation of the onus of proof and so it may be anticipated the proposition derived from them will not develop into a significant onus being placed on the Commissioner.

Second, a taxpayer might take an approach outside of that envisaged by the remarks in *Buckley & Young* and attempt to impugn the Commissioner's method of apportionment. The contention would be along the lines that, for one reason or another, the Commissioner's method is arbitrary and it is the taxpayer's more rational method which produces a fair and reasonable assessment. The foundation of this argument is *Lowe* v. *C.I.R.*[118]

One of the arguments of the taxpayers in *Lowe* was whether the Commissioner must achieve sufficient accuracy, if not mathematical certainty, before his assessment of the profits or gains from a taxable land subdivision scheme could be sustained. The contention was rejected on the ground that the profits or gains are to be calculated by the application of ordinary commercial principles even though this might entail the exercise of judgment by the Commissioner.[119] At the same time the Court of Appeal made it clear that the Commissioner bears some responsibility to formulate a rational assessment. Cooke J. said:[120]

110 *Lowe* v. *C.I.R.* [1981] 1 N.Z.L.R. 326, 345
111 *Sun Insurance Office* v. *Clark* (1912) 6 T.C. 59, 75; a comment made in the equally imprecise context of determining what percentage of the premium income of a fire insurer should be taken to a reserve for unexpired risks.
112 *Buckley & Young Ltd.* v. *C.I.R.* [1978] 2 N.Z.L.R. 485, 499.
113 *Handley* v. *F.C.T.* (1981) 148 C.L.R. 182, 193.
114 *Lowe* v. *C.I.R.* [1981] 1 N.Z.L.R. 326, 344-345.
115 (1974) 1 N.Z.T.C. 61, 169.
116 [1971] N.Z.L.R. 641.
117 (1974) 1 N.Z.T.C. 61, 169, 61, 195.
118 [1981] 1 N.Z.L.R. 326.
119 Ibid., 345-346.
120 Ibid., 336.

> I accept that a case might arise in which the objector could discharge the onus by showing that the Commissioner's assessment was no more than an arbitrary conjecture or was demonstrably unfair. This may amount to much the same as saying that initially or at the threshold there is an onus on the Commissioner to point to what is prima facie a proper assessment, but I prefer the first way of putting it, as fitting the Act better.

The other members of the Court made only brief remarks on the point. Richardson J. said "[i]f the assessment is not made on an intelligible basis, it cannot stand",[121] while McMullin J. commented " . . . an assessment may so lack any sensible basis as to be quite insupportable."[122] Together these remarks lend themselves to an argument that in an apportionment case, another instance of proceeding by estimate, it must be established that the Commissioner's method is at least rational. The High Court has rejected application of *Lowe* to apportionment problems.

Pacific Rendezvous Ltd. v. *C.I.R.*[123] concerned a claim to deduct interest paid on funds borrowed to enable a motelier to build additional motel units. Development was undertaken to maximise the capital gain which might be realised upon the imminent sale of the undertaking and to increase earnings from the business. To exclude the capital content of the interest payments the taxpayer adopted one method[124] and the Commissioner another.[125] The taxpayer relied upon *Lowe* to argue there was a threshold obligation on the Commissioner to show that the assessment was made in a manner which was sensible and intelligible and went beyond mere conjecture. The High Court said the concept of a threshold obligation applied when assessing income " . . . on some special basis unrelated to any conventional assessment of income."[126] It did not apply to deduction cases. In so far as the present case was concerned, the Commissioner was entitled to conclude that the taxpayer's method made a greater attribution to revenue than could be justified.[127] It had not been established by the taxpayer that the Commissioner's apportionment should have been at any figure other than that allowed.[128] Three comments are warranted.

The first concerns the question of whether the High Court appreciated the precise effect of *Lowe's case*. The remarks made there suggest there is a "threshold question"[129] whether the Commissioner's assessment is arbitrary. If the taxpayer can show that it is, he will have, as Cooke J. said, discharged the onus of proof he bears. To point out this means by which the taxpayer may discharge the onus of proof is not to assert there is a "threshold obligation" on the Commissioner to show that his assessment is not arbitrary.

121 Ibid., 348.
122 Ibid., 359.
123 (1984) 6 N.Z.T.C. 61, 725.
124 Broadly, the interest excluded was that incurred during development plus that paid in excess of the normal borowing rate of 12%.
125 The interest excluded was 75% of the interest paid (1984) 6 N.Z.T.C. 61, 725, 61, 730.
126 Ibid., 61, 731.
127 Ibid., 61, 735.
128 Idem.
129 [1981] 1 N.Z.L.R. 326, 348.

The second concerns the High Court's rejection, in an apportionment case, of the proposition that it must be established that the Commissioner's assessment is not arbitrary. An argument can be raised that the High Court erred in distinguishing an apportionment case from the sort of problem considered in *Lowe's case*. The similarities between the two are strong. Both concern an area where precision is unattainable so methods of estimate must be employed.[130] The fundamental question in each case becomes " . . . to decide which of the rival accounting methods will be better calculated to produce the more accurate picture of the actual profit figure in each year."[131] With the same common problem it is appropriate that in each class of case it must be determined, in the first instance, whether the Commissioner selected a method which produces an arbitrary assessment.

The third comment is whether the right approach was taken in *Pacific Rendezvous*. In that case only the taxpayer's method of apportionment was examined. It was perceived to have shortcomings so it did not adequately discharge the onus of proof. The High Court, because it did not recognise the threshold question, did not examine the Commissioner's method to see whether it, too, had any flaws.[132] Nor did the Court compare the two to see which was the more compelling. These omissions support an argument that *Pacific Rendezvous* does not represent the approach which ought to be taken in an apportionment case. It is not enough merely to examine the taxpayer's method for flaws. The same exercise must be carried out in relation to the Commissioner's method. The Court must weigh the balance between the two, bearing in mind that the taxpayer bears the onus of proof and he has, so to speak, entered the contest from behind scratch.[133] It is only by this comparative process of evaluating the alternatives that the objective of making a fair and reasonable assessment can be realised. To confirm the Commissioner's method only on the basis of errors in the taxpayer's approach may result in endorsement of a method which is even more unsound.

IV. CONCLUSION

Section 104 of the Income Tax Act 1976 is an omnibus provision for most expenses which help earn income. A general standard is adopted, presumably to foster equity of treatment amongst the various sorts of expenses, with express exceptions inserted for economic policy reasons or to restore legislative intent following an unfortunate court decision. Leading cases under the general standard in the areas of the degree of asset use, the question of benefit to another party, and collateral benefits and apportionment exhibit unsatisfactory features. Developments of this kind are an unwelcome if not inevitable outcome of such a legislative approach.

130 This was recognised by Richardson J: *Lowe* v. *C.I.R.* [1981] 1 N.Z.L.R. 326, 344-345.

131 *C.I.R.* v. *Farmers' Trading Co. Ltd.* [1982] 1 N.Z.L.R. 449, 456; a comment made in the context of determining the appropriate method of tax accounting.

132 Details of the method employed by the Commissioner were not disclosed. All that was revealed was the assertion that it would produce an " . . . estimate of what would be fair and reasonable to both parties"; (1984) 6 N.Z.T.C. 61, 725, 61, 729.

133 *C.I.R.* v. *Legarth* [1969] N.Z.L.R. 137, 148.