Foll *Anovoy Pty Ltd v FCT* (2000) 44 ATR 507

PRIVY COUNCIL. 1937.

LAKE VIEW AND STAR LTD. *v.* COMINELLI AND BONAZZI.

it " (1). Their Lordships concur in what was there said, and with equal lack of encouragement.

Their Lordships will humbly advise His Majesty that this appeal be dismissed. The appellants must pay the costs of the appeal.

Solicitors for the appellant, *Birkbeck Julius, Edwards & Co.*

Solicitors for the respondents, *Gregory Rowcliffe & Co.*

Cons *Telecasters North Qld Ltd v FCT* 20 ATR 637

Foll *Coles Myer Finance Ltd v FCT* 21 ATR 1185

Foll *Coles Myer Finance Ltd v FCT* 98 ALR 411

Appl *Coles Myer Finance Ltd v Commissioner of Taxation* (1991) 28 FCR 7

Dist *Coles Myer Finance Ltd v FCT* (1993) 25 ATR 95

Cons *Coles Myer Finance Ltd v FCT* (1993) 67 ALJR 463

Cons *Coles Myer Finance Ltd v Federal Commissioner of Taxation* (1993) 176 CLR 640

Appl *Associated Minerals Consolidated Ltd v FCT* (1994) 27 ATR 542

Appl *FCT v Australian Guarantee Corporation Ltd* (1984) 54 ALR 209

Discd *FCT v James Flood Pty Ltd* (1953) 88 CLR 492

Appl *A A T Case 26/97; No 11,874* (1997) 36 ATR 1001

Foll *Morris v FCT* (2002) 50 ATR 104

[HIGH COURT OF AUSTRALIA.]

W. NEVILL AND COMPANY LIMITED . APPELLANT;

AND

THE FEDERAL COMMISSIONER OF TAXATION RESPONDENT.

H. C. OF A. 1936-1937.

SYDNEY, 1936, *Dec.* 1.

MELBOURNE, 1937, *Mar.* 8.

Latham C.J., Rich, Dixon, and McTiernan JJ.

Income Tax (Cth.)—Assessable income—Deduction—Managing director—Contract of service—Termination—Allowance by company—Purpose—Outgoings " actually incurred in gaining or producing assessable income "—" Money wholly and exclusively laid out or expended for the production of assessable income "—Income or capital expenditure—Allowance paid during two income years—When deductible —Income Tax Assessment Act 1922-1932 (*No.* 37 *of* 1922—*No.* 76 *of* 1932), *secs.* 23 (1) (*a*), 25 (*e*).

A company, which previously had been managed by one managing director, in July 1930 introduced a system of joint management, and under an agreement appointed an additional managing director for a term of five years from 1st July 1930 at a salary of £1,500 per annum with a percentage of profits. In August 1930 the salaries of the managing directors were reduced for six months without prejudice to rights under any service agreement. The system of joint management did not work out satisfactorily and tended to impair the efficient management of the business, and, in the belief that its abolition would lead to increased efficiency, and with a view to saving his salary, an arrangement was made in March 1931 for the resignation of the additional managing director under which the company agreed to pay him a sum of £2,500 in consideration

(1) (1934) 51 C.L.R., at pp. 556, 557.

of his cancelling his agreement. Of this sum the company paid £1,500 cash and met ten promissory notes for £100 each, one being paid in each month from March to December 1931. The company claimed to deduct this sum of £2,500 from its assessable income in respect of the income year ended 30th June 1931.

Held that the sum of £2,500 was a loss or outgoing incurred in gaining or producing assessable income within the meaning of sec. 23 (1) (*a*) of the *Income Tax Assessment Act* 1922-1932, and its deduction therefrom was not prohibited by sec. 25 (*e*) of the Act, because it was money wholly and exclusively laid out in the production of such assessable income. The sum of £1,900, being that part of the sum of £2,500 which was paid during the income year in question, was therefore deductible from the assessable income of that year.

Per Dixon and *McTiernan* JJ.: The amount deducted from the assessable income of any particular income year should be limited to the amount actually paid in that year.

CASE STATED.

On the hearing of an appeal to the High Court by W. Nevill & Co. Ltd. from an assessment of that company by the Federal Commissioner of Taxation for income tax for the financial year ended 30th June 1932, *Evatt* J., under sec. 51A of the *Income Tax Assessment Act* 1922-1932, stated a case, which was substantially as follows, for the opinion of the Full Court:—

1. W. Nevill & Co. Ltd. (hereinafter called the company) is a company duly incorporated under the laws of New South Wales and carried on the business of manufacturing stationers etc. in that State.

2. Mr. William Nevill who was managing director of the company explained to his co-directors shortly before 30th June 1930 that by reason of his indifferent health he thought it advisable that someone should be brought into the business to help him in its management and it was decided to leave the matter in the hands of Nevill.

3. On 11th July 1930 an agreement was entered into between the company of the one part and Laurance Leonard King of the other part whereby the company employed King as joint managing director of the company with Nevill for a term of five years from 1st July 1930 at a remuneration of £1,500 per annum together with a certain percentage of the profits. If King committed a breach of the agreement or became disqualified from holding the

office of director the company was immediately to be at liberty to terminate the agreement.

4. On 11th August 1930 at a meeting of the board of the company it was agreed that the salaries of King, Nevill and one George Gordon Bretnall should be reduced for a period of six months from 1st August 1930 without prejudice to rights under any service agreement.

5. On 17th February 1931 at a meeting of the board of the company Nevill stated that he thought that the salaries of King, Bretnall and himself should be fixed at the same amount, namely, £1,000 per annum less ten per cent. King stated that this proposition was a surprise to him and asked that the matter should be allowed to stand over in order that he might have time to give it consideration.

6. On 5th March 1931 King wrote to the company a letter as follows :—" To W. Nevill & Co.—I am prepared to resign my position as a managing director of the company from the 9th day of March 1931, and cancel my agreement with the company upon the company agreeing to pay me the sum of £2,500 as follows :—£1,500 cash and the balance of £1,000 by ten equal monthly instalments of £100 terminating December 1931 to be covered by ten promissory notes of the company. I, of course, will still remain an ordinary director of the company. (Sgd.) Laurance L. King."

7. This letter was considered by the company on 6th March 1931 when the company carried the following resolution :—" That owing to the difficult times and for the purpose of reducing overhead expenses the offer of Mr. King, contained in his letter of the fifth March 1931, be accepted and that the Secretary notify Mr. King accordingly. That Mr. King be paid the sum of £1,500 and be given ten promissory notes of £100 in terms of the agreement upon his signing the necessary document of his cancellation of his agreement."

8. In pursuance of that resolution the company paid to King the sum of £1,500 in cash on 9th March 1931 and on that date handed him ten promissory notes each for £100 payable respectively from March to December 1931 inclusive. Thereupon the agreement of 11th July 1930 was cancelled. The promissory notes were all duly met when presented.

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9. Prior to the making of the agreement of 11th July 1930 King did not hold any shares in the company and on 6th March 1931 he held 1,300 shares in the company which had then issued 40,502 shares.

10. Prior to his employment by the company King had been employed in Alexander Cowan Co. Ltd. as manager and as that company was carrying on business similar to that carried on by the company it was expected by the company that King would be able to introduce to it a considerable amount of new business. The anticipation that King would introduce new business was not realized.

11. The profits of the company during the years ended 30th June 1930 to 1934 inclusive as shown in its profit and loss account were as follows: 1930 £4,125 0s. 9d., 1931 £357 4s. 8d., 1932 £3,172 10s. 5d., 1933 £4,242 18s. 8d., 1934 £4,561 11s. 8d. In calculating the profits for the year ended 30th June 1931, the amount of £2,500 referred to in par. 6 hereof and the ordinary salary paid to King during that year, were deducted.

12. The system whereby Nevill and King acted as joint managing directors of the company did not work out satisfactorily. Nevill did not receive from the other the assistance that had been anticipated. The system of joint control tended to impair the efficient management of the business and caused some discontent amongst the shareholders who were employees. Twenty-five per cent of the one hundred employees were shareholders.

13. The main object of the directors in accepting the offer contained in King's letter of 5th March was to effect a saving of the salary to which King would otherwise be entitled. At the same time the directors believed that the abolition of the system of joint control would tend to increase the efficiency of the company.

14. In its return for income tax purposes for the year of income ended 30th June 1931 the company claimed as a deduction the sum of £2,500 paid to King as set out in par. 8 hereof. The Commissioner of Taxation disallowed that deduction whereupon the company lodged an objection.

15. The commissioner disallowed the objection so far as it related to the sum of £2,500, whereupon, at the request of the

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company, the objection was treated as an appeal and forwarded to the High Court.

The following question was stated for the opinion of the Full Court:

> Whether on the facts stated herein the commissioner in calculating the taxable income of the company should have allowed a deduction from its assessable income of the said year of the said sum of £2,500 or any and if so what part thereof ?

Gain, for the appellant. The case stated shows that the payment of the money was made for the purpose of saving the business expense which produced the income of the appellant company, thus saving the business further expenditure. An incidental purpose was that it made for the more efficient management and control of the business. It was held in *Farmer* v. *Cotton's Trustees* (1) that, where all the material facts are found, the question whether the matter comes within the scope of a particular statute is one of law only, but in *Federal Commissioner of Taxation* v. *Gordon* (2) and *Maryborough Newspaper Co. Ltd.* v. *Federal Commissioner of Taxation* (3) this court expressed a contrary opinion. The money was a loss or outgoing not of a capital nature, actually incurred in gaining or producing assessable income (sec. 23 (1) (*a*)). It was wholly and exclusively laid out or expended for the production of assessable income (sec. 25 (*e*)). In the circumstances the payment was not voluntarily made by the appellant (*Union Trustee Co. of Australia Ltd.* v. *Federal Commissioner of Taxation* (4)). Business expediency dictated that it should be paid (*Mitchell* v. *B. W. Noble Ltd.* (5) ; *Maryborough Newspaper Co. Ltd.* v. *Federal Commissioner of Taxation* (3)).

[Rich J. referred to *British Insulated and Helsby Cables* v. *Atherton* (6).]

The test is : Was the money expended only for the purpose of carrying on the business more efficiently ? (*Maryborough Newspaper*

(1) (1915) A.C. 922, at p. 932.
(2) (1930) 43 C.L.R. 456.
(3) (1929) 43 C.L.R. 450.
(4) (1935) 53 C.L.R. 263.
(5) (1927) 1 K.B. 719.
(6) (1926) A.C. 205, at p. 212.

Co. Ltd. v. *Federal Commissioner of Taxation* (1); *Federal Commissioner of Taxation* v. *Gordon* (2); *Toohey's Ltd.* v. *Commissioner of Taxation for New South Wales* (3); *Amalgamated Zinc* (*De Bavay's*) *Ltd.* v. *Federal Commissioner of Taxation* (4)). The payment did not bring into existence an asset or advantage for the enduring benefit of the business (*British Insulated and Helsby Cables* v. *Atherton* (5); *Anglo-Persian Oil Co.* v. *Dale* (6)).

[Dixon J. referred to *Van Den Berghs Ltd.* v. *Clark* (7).]

The payment was not made in respect of a permanent benefit. The mere fact that the money was paid in a lump sum did not change its nature from income to capital (*Mitchell* v. *B. W. Noble Ltd.* (8)). The amount represented by the whole of the promissory notes should be deducted from the income of the income year in which the notes were made.

[Dixon J. referred to *Herald & Weekly Times Ltd.* v. *Federal Commissioner of Taxation* (9) and *Amalgamated Zinc* (*De Bavay's*) *Ltd.* v. *Federal Commissioner of Taxation* (10).]

The liability was incurred immediately upon the making of the promissory notes.

Roper, for the respondent. The allowance made to the retiring managing director is not a deduction authorized by the Act. Even if it is, deduction in respect of the promissory notes may be made from the assessable income of that year only in which the several promissory notes were met. The money represented by each particular note is not a loss or outgoing "actually incurred" within the meaning of sec. 23 (1) (*a*) until the note is actually met. The appellant is a company; therefore as the flat rate applies, this aspect of the matter is not of any material importance. Here confusion has arisen, based on decisions of the English courts, by reason of the difference between the English Act and the *Income Tax Assessment Act.* That difference has been adverted to in this court in *Federal Commissioner of Taxation* v. *Gordon* (2), *Herald & Weekly Times*

(1) (1929) 43 C.L.R. 450.
(2) (1930) 43 C.L.R. 456.
(3) (1922) 22 S.R. (N.S.W.) 432.
(4) (1935) 54 C.L.R. 295, at pp. 303, 307, 309.
(5) (1926) A.C., at p. 213.
(6) (1932) 1 K.B. 124; (1931) 16 Tax Cas. 253, at p. 262.
(7) (1935) A.C. 431, at pp. 438-443.
(8) (1927) 1 K.B. 719.
(9) (1932) 48 C.L.R. 113, at p. 118.
(10) (1935) 54 C.L.R., at pp. 309, 310.

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Ltd. v. *Federal Commissioner of Taxation* (1) and *Egerton-Warburton* v. *Deputy Federal Commissioner of Taxation* (2). The English Act disallows deductions of expenditure unless made wholly and exclusively for the purposes of the trade or business (*Mitchell* v. *B. W. Noble Ltd.* (3)). The corresponding provision in the *Income Tax Assessment Act*, sec. 25 (*e*), disallows the deduction unless the money is wholly and exclusively laid out or expended for the production of assessable income. Here the main purpose of the expenditure was to reduce an outgoing ; therefore it was not wholly and exclusively laid out for the purpose of producing assessable income within the meaning of sec. 25 (*e*). The test that should be applied under sec. 25 is as stated by *Rich* J. in *Maryborough Newspaper Co. Ltd.* v. *Federal Commissioner of Taxation* (4). In *Federal Commissioner of Taxation* v. *Gordon* (5) and *Mitchell* v. *B. W. Noble Ltd.* (3), there were express findings of fact in favour of the taxpayer. It did not necessarily follow from the mere fact that the employment of the retiring managing director was unsatisfactory and may have caused internal friction, that the trading of the appellant company itself was affected, and that its assessable income would have been reduced or diminished if there had not been a retirement. Money expended for the protection and preservation of a company and its trade or business is not necessarily an expenditure incurred exclusively in the production of assessable income (*Ward & Co.* v. *Commissioner of Taxes* (6)). A retiring allowance is not deductible (*Union Trustee Co. of Australia Ltd.* v. *Federal Commissioner of Taxation* (7)). Here the payment was made to determine an existing contract of service, and to avoid liabilities under that contract. That payment was an outgoing of capital within the meaning of sec. 23 (1) (*a*) (*Scott* v. *Commissioner of Taxation* (8) ; *Californian Oil Products Ltd.* v. *Federal Commissioner of Taxation* (9)).

[Dixon J. referred to *Commissioner of Taxes* (*Vict.*) v. *Phillips* (10).]

(1) (1932) 48 C.L.R. 113.
(2) (1934) 51 C.L.R. 568.
(3) (1927) 1 K.B. 719.
(4) (1929) 43 C.L.R., at p. 455.
(5) (1930) 43 C.L.R. 456.
(6) (1923) A.C. 145.
(7) (1935) 53 C.L.R., at pp. 269, 270.
(8) (1935) 35 S.R. (N.S.W.) 215.
(9) (1934) 52 C.L.R. 28.
(10) (1936) 55 C.L.R. 144.

A capital payment in the hands of the payee must be capital expenditure in the hands of the payer unless expenditure of that nature and for that purpose is a usual and normal feature of the payer's business.

Gain, in reply. The expenditure was properly incurred in carrying on the appellant's business, and, therefore, was incurred in the production of assessable income from that business (*Toohey's Ltd.* v. *Commissioner of Taxation for New South Wales* (1) ; *Amalgamated Zinc* (*De Bavay's*) *Ltd.* v. *Federal Commissioner of Taxation* (2)). It is not necessary in order that a taxpayer may bring his case within sec. 25 (*e*) that he should show that the expenditure of itself produced assessable income. It is sufficient to show that it was expenditure incurred in the business and in the course of the business which produced the income (*Federal Commissioner of Taxation* v. *Gordon* (3)). The payment was not made voluntarily by the taxpayer as in *Union Trustee Co. of Australia Ltd.* v. *Federal Commissioner of Taxation* (4)).

Cur. adv. vult.

1937, Mar. 8.

The following written judgments were delivered :—

LATHAM C.J. This is a case stated by *Evatt* J. under the *Income Tax Assessment Act* 1922-1932, sec. 51A (8).

The appellant is a company carrying on business in New South Wales. Before July 1930 the company had been managed by a single managing director. In that month the board of directors decided to introduce a system of joint management, and L. L. King was appointed as an additional managing director. He was engaged under an agreement, dated 11th July 1930, for a term of five years from the 1st July 1930 at a salary of £1,500 per annum with a percentage of profits. Almost immediately, in August 1930, it was determined that, as business had seriously decreased, the salaries of the managing directors should be reduced for six months, but without prejudice to rights under any service agreement. In March

(1) (1922) 22 S.R. (N.S.W.), at p. 440.
(2) (1935) 54 C.L.R., at p. 307.
(3) (1930) 43 C.L.R., at p. 469.
(4) (1935) 53 C.L.R. 263.

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1931 an arrangement was made for the resignation of King under which the company agreed to pay him a sum of £2,500 in consideration of his cancelling his agreement, £1,500 to be paid in cash and the balance of £1,000 by ten equal monthly payments of £100 up to December 1931, these payments to be covered by ten promissory notes of the company. The learned judge has found that the system of joint management did not work out satisfactorily and that it tended to impair the efficient management of the business. He also found that the main object of the directors in making the arrangement for King's resignation was to effect a saving of King's salary and that at the same time the directors believed that the abolition of the system of joint control would tend to increase the efficiency of the company. The company paid the £1,500 in cash and met the ten promissory notes for £100 each, one being paid in each month from March to December 1931.

The company seeks to deduct the said sum of £2,500 from its assessable income in respect of the income year ending 30th June 1931. The commissioner disallowed the deduction and disallowed an objection against his decision, whereupon the company appealed to the High Court. This case, stated in the appeal, asks whether upon the facts stated the deduction claimed should have been allowed.

The relevant sections of the *Income Tax Assessment Act* 1922-1932 are as follows :—

"23. (1) In calculating the taxable income of a taxpayer the total assessable income derived by the taxpayer shall be taken as a basis, and from it there shall be deducted—(*a*) all losses and outgoings (including commission, discount, travelling expenses, interest and expenses, and not being in the nature of losses and outgoings of capital) actually incurred in gaining or producing the assessable income. 25. A deduction shall not, in any case, be made in respect of any of the following matters :— . . . (*e*) money not wholly and exclusively laid out or expended for the production of assessable income."

1. If the expenditure in question represents a loss or outgoing of capital it cannot be deducted under the authority of sec. 23 (1) (*a*) or any other provision of the Act.

In *British Insulated and Helsby Cables* v. *Atherton* (1) Viscount *Cave* L.C., referring to expenditures, said : " When an expenditure is made, not only once and for all, but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade, I think that there is very good reason (in the absence of special circumstances leading to an opposite conclusion) for treating such an expenditure as properly attributable not to revenue but to capital." The principle here enunciated provides a positive test the application of which may show that a particular expenditure —or *e converso*—a particular receipt, is a capital expenditure or receipt. In *Ward & Co.* v. *Commissioner of Taxes* (2) the question was whether the deduction of expenditure by a brewing company in opposing proposals for prohibition in a public campaign should be allowed for purposes of income tax in the face of a provision prohibiting a deduction of any expenditure not exclusively incurred in the production of the assessable income from a particular source. It was held that the expenditure was directed to preventing the extinction of the business from which all the income of the company was derived and that it was therefore not incurred exclusively or at all for the production of the assessable income in question. It was directed towards the preservation of the whole of the business assets of the company. Such an expenditure is distinguishable from current expenditure upon the maintenance or repair of a particular asset. It was held in *Ward's Case* (2) that the expenditure was a capital outgoing. The decision in *Ward's Case* (2), it may be observed, raises doubts as to the soundness of some of the reasoning in *Toohey's Ltd.* v. *Commissioner of Taxation for New South Wales* (3).

In the case of receipts, the principle has been applied to moneys received, not in the ordinary way of trading, but as payment made to a taxpayer company by another company for the purpose of securing the cancellation of a set of agreements which regulated the whole conduct of the profit-making enterprise of the taxpayer company. It was held that the whole congeries of rights which the taxpayer enjoyed under these agreements was a capital asset and

(1) (1926) A.C., at pp. 213, 214.
(2) (1923) A.C. 145.
(3) (1922) 22 S.R. (N.S.W.) 432.

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that the price received for the surrender of these rights must be regarded as a capital receipt (*Van Den Berghs Ltd.* v. *Clark* (1)).

Circumstances of this character are not to be found in the present case. No asset was acquired by the expenditure of the sum of £2,500. The agreement between the company and King for the employment of King was not something affecting the whole structure of the company's business. Its cancellation cannot be regarded as involving the acquisition of a capital asset. The cancelled agreement was an agreement for the employment of a servant made in the ordinary course of the company's business. I am unable to discern any reason which would justify the conclusion that the £2,500 was a capital expenditure.

2. But in order to justify a deduction under sec. 23 (1) (*a*) the outgoing in question must be actually incurred in gaining or producing the assessable income.

The payments in question were actually made bona fide in the course of business in the interests of the efficiency of the business. In my opinion they fall within the terms of the proposition of Viscount *Cave* L.C. in *British Insulated and Helsby Cables* v. *Atherton* (2) : " A sum of money expended, not of necessity and with a view to a direct and immediate benefit to the trade, but voluntarily and on the grounds of commercial expediency, and in order indirectly to facilitate the carrying on of the business, may yet be expended wholly and exclusively for the purposes of the trade." The words " for the purposes of the trade " come from Schedule D. of the English *Income Tax Act* 1842. They do not appear in sec. 23 (1) (*a*) of the Federal Act. The words in sec. 23 (1) (*a*) are " in gaining or producing the assessable income." The principle asserted in Viscount *Cave's* statement is, however, equally applicable to a case arising under sec. 23 (1) (*a*). The facts stated in this case show that the expenditure was actually incurred in gaining or producing the assessable income of the year in question. The expenditure was made for the purpose of increasing the efficiency of the company and therefore increasing its income producing capacity. It was not a capital expenditure, it was, in my opinion, an expenditure incurred in the

(1) (1935) A.C., at p. 443.

(2) (1926) A.C., at p. 212.

course of gaining or producing assessable income (See *Amalgamated Zinc* (*De Bavay's*) *Ltd.* v. *Federal Commissioner of Taxation* (1)).

It is urged, however, that in so far as the expenditure was directed towards reducing current and future expenses by securing relief from the onerous contract to pay £1,500 to King for five years, it did not increase assessable income. Assessable income is gross income (See sec. 4). The mere reduction of expenditure, though it decreases the expenditure side of an account, does not increase the receipts side of the same account. In my opinion the answer to this contention is to be found in a recognition of the fact that it is necessary, for income tax purposes, to look at a business as a whole set of operations directed towards producing income. No expenditure, strictly and narrowly considered, in itself actually gains or produces income. It is an outgoing, not an incoming. Its character can be determined only in relation to the object which the person making the expenditure has in view. If the actual object is the conduct of the business on a profitable basis with that due regard to economy which is essential in any well-conducted business, then the expenditure (if not a capital expenditure) is an expenditure incurred in gaining or producing the assessable income. If it is not a capital expenditure it should be deducted in ascertaining the taxable income of the taxpayer.

3. It is now necessary to consider whether the deduction of the expenditure in question is prohibited by sec. 25 (*e*), which forbids the deduction of any money not wholly and exclusively expended for the production of assessable income. Under head 2 above I have already dealt to some extent with this aspect of the case and have expressed the opinion that the expenditure was incurred in gaining or producing assessable income. The question which it is now necessary to determine is whether it was wholly and exclusively laid out or expended for that purpose. The same question arose under similar circumstances in *Mitchell* v. *B. W. Noble Ltd.* (2). In that case a company paid a sum of money as the price of getting rid of a life director whose presence on the board was regarded as detrimental to the conduct of the company's business (See the acceptance of this case as rightly decided in *Van Den Berghs Ltd.*

(1) (1935) 54 C.L.R. 295. (2) (1927) 1 K.B. 719.

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v. *Clark* (1)). It was held that the expenditure was an income expenditure and that it could properly be deducted as money "wholly and exclusively laid out and expended for the purposes of the trade." All the relevant circumstances are the same as in the case now before the court, and, in my opinion, *Mitchell's Case* (2) is sufficient authority to justify the conclusion that the deduction claimed is not prohibited by reason of sec. 25 (*e*).

4. The only remaining question is whether the whole sum of £2,500 should be deducted from the income derived in the year ending 30th June 1931. In that year £1,500 was paid in cash and four promissory notes for £100 each were paid. There were six promissory notes each for £100 outstanding. These fell due and were paid at dates in each month from July to December 1931. The taxpayer claims that not only the £1,900 actually paid in the year ending 30th June 1931 should be deducted but also that the further £600 payable under the six outstanding promissory notes should be deducted as outgoings actually incurred in that year. This contention raises what, in my opinion, is a difficult question. The outgoing, in order to be deducted, must be an outgoing "actually incurred" (sec. 23 (1) (*a*)). The word used is "incurred" and not "made" or "paid." The language lends colour to the suggestion that, if a liability to pay money as an outgoing comes into existence, the quoted words of the section are satisfied even though the liability has not been actually discharged at the relevant time. The word "actually" is not inconsistent with this view. It is only the incurring of the outgoing that must be actual; the section does not say in terms that there must be an actual outgoing—a payment out. On the other hand the section does not speak of debts or liabilities, but of losses and outgoings. As a general rule the word "outgoing" in itself would be understood to be limited to money that actually went out and not to include money which would go out at some future time. It is impossible to avoid the reflection that, if it were held that deductions could be obtained in any given year by the simple process of signing promissory notes in respect of genuine liabilities which would not fall due until that year had expired, a taxpayer would be able, by such action, to influence the

(1) (1935) A.C., at p. 441. (2) (1927) 1 K.B. 719.

rate of tax in his own favour in an exceptionally profitable year. The question is, therefore, one of considerable importance. This question was not argued in the present case because the promissory notes outstanding on the 30th June 1931 have since been paid and the deduction can be claimed in respect of the income of the following year. The taxation of companies is at a flat rate, and therefore it is immaterial to the parties whether or not the £600 representing the later promissory notes should be deducted in respect of the earlier year. For that reason it is not necessary to give a reasoned decision upon the question mentioned. I would require to hear full argument before deciding this question. I merely state my view, not as a concluded opinion, but in order to reach a determination in this case, that the sum of £600 should be deducted from the income of the year ending 30th June 1932 and not from the income of the preceding twelve months.

The question in the case should be answered by stating that £1,900, part of the said £2,500, should be allowed as a deduction.

Rich J. Case stated by *Evatt* J. The question propounded involves two distinct inquiries. The first is whether the sum which the taxpayer claims to deduct was an expenditure of an income or of a capital nature, and the second is whether within the meaning of sec. 25 (*e*) of the *Income Tax Assessment Act* 1922-1932 this sum was wholly and exclusively laid out or expended for the production of assessable income. In my opinion the sum constitutes an expenditure on account of income and it was wholly and exclusively laid out for the production of assessable income. The sum in question was a payment made to one of two joint managing directors of the taxpayer company in consideration of his agreeing to the rescission of a contract entitling him to retain that office for another four years or more at a salary of £1,500. The company's purpose in effecting the transaction was to save the salary and at the same time to put an end to joint control. In such an expenditure I can see no characteristics which would make it referable to capital account. There is nothing analogous to the acquisition of a fixed asset, to the enlargement of the goodwill of a company or, as in *Ward's Case* (1), to the rescue of the business from annihilation. The question in the

(1) (1923) A.C. 145.

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present case arose in relation to the staff and although, owing to the superior position of the officer, it was an important one and unlikely to recur, in other respects it was of a description which must arise over and over again in the conduct of any business where there is a large staff many of whom have a fixed tenure under contract. The expenditure was made as an incident in the organization of the company's officers. The case law dealing with such matters will be found in *Van Den Berghs Ltd.* v. *Clark* (1) and in *Anglo-Persian Oil Co.* v. *Dale* (2). The sum is not an expense which fulfils any of the tests laid down in those authorities for an expenditure of a capital nature. The second inquiry depends upon the purpose for which the expenditure was made. The contention for the Commonwealth is that, as admittedly the object of making the lump sum payment was to save the future expenditure of the joint managing director's salary, it could not be exclusively and wholly laid out for the production of assessable income. For it was said to avoid expenditure is not to obtain assessable income. This argument seems to me to confine the investigation of the purpose to a stage later than that to which the taxpayer is entitled to go back. The taxpayer had committed itself at an anterior date to an expenditure on salaries for its managing directors. Its sole purpose in doing so was to earn income ; but later the company found that in the prosecution of this purpose it had committed itself to a future expenditure unnecessarily large. It then negotiated what may be described as a commutation of the excess future expenditure it had otherwise incurred. So regarded, the purpose of the whole transaction was to gain assessable income. The commissioner cannot rivet attention on the last stage to the exclusion of the earlier stage of the course of dealing which leads to the total expenditure.

The interesting question to which year or years the expenditure should be allocated in view of the fact that it was secured by promissory notes maturing over two years was not raised by the commissioner or argued by counsel. I do not propose to consider it and am content to adopt the course proposed by the Chief Justice without deciding the question of law.

The question in the case should be answered in the affirmative.

(1) (1935) A.C. 431. (2) (1932) 1 K.B. 124.

DIXON J. The deduction claimed by the taxpayer company is for a payment made, in cash or by negotiable instrument, during the year of income in order to obtain the resignation of one of its two joint managing directors. He had been appointed at a salary of £1,500 for a term of five years of which more than four were unexpired. The system of joint managership proved undesirable, if not unworkable, and when in the depression the question arose whether the two managing directors should not consent to a reduction of salary, it was made the occasion for negotiating an arrangement with one of them for his retirement. He agreed to resign in consideration of a sum of £2,500, of which £1,500 was paid immediately and the balance of £1,000 was secured by ten promissory notes of £100 payable at intervals of a month.

The question is whether the sum of £2,500, or any part of it, should be deducted from the assessable income. The question is governed by sec. 23 (1) (*a*) and sec. 25 (*e*) of the *Income Tax Assessment Act* 1922-1932. Under the first of these provisions it is necessary that the expenditure should have been incurred in gaining or producing the assessable income, that is the assessable income of the given financial year or accounting period. This means that it must have been incurred in the course of gaining or producing the assessable income. It does not require that the purpose of the expenditure shall be the gaining or production of the income of that year. The condition the provision expresses is satisfied if the expenditure was made in the given year or accounting period and is incidental and relevant to the operations or activities regularly carried on for the production of income. This is explained in *Amalgamated Zinc (De Bavay's) Ltd.* v. *Federal Commissioner of Taxation* (1).

The expenditure upon the retiring allowance of the managing director appears to me to fulfil this test, except for the circumstance that some of the promissory notes fell due outside the financial year.

But sec. 23 (1) (*a*) imposes another and a negative condition. The expenditure must not be of a capital nature. For the commissioner it is contended that in, so to speak, buying out the managing director, the taxpayer company, in effect, commuted its loss on his

(1) (1935) 54 C.L.R., at pp. 303, 307, 309, 310.

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future salary for an immediate capital payment. Some of the reasons given in support of the argument treated the question whether the payment of the retiring allowance by the company should be considered as part of its capital expenditure as interdependent with the question whether its receipt by the managing director should be considered part of his assessable income or as an addition to his capital. In my opinion there is no necessary connection between the two questions and, indeed, an attempt to obtain guidance in the solution of one by considering the other is not without danger. The question whether a receipt or expenditure is to be treated as on account of income or capital depends upon the relation of the taxpayer to the payment in question. If a company conducting an organized business of buying land and selling it in subdivision happens to purchase an area of land hitherto held for the purpose of agriculture, the purchase money will undoubtedly be capital in the hands of the vendor, but it will be treated as expenditure of an income nature in making up the profit and loss account of the company.

In the present case the payment of a lump sum to secure the retirement of a high executive officer may have been unusual. But it was made for the purpose of organizing the staff and as part of the necessary expenses of conducting the business. It was not made for the purpose of acquiring any new plant or for any permanent improvement in the material or immaterial assets of the concern. The purpose was transient and, although not in itself recurrent, it was connected with the ever recurring question of personnel.

In my opinion it was not an outgoing of a capital nature.

Under sec. 25 (*e*) a different question arises. That provision forbids the deduction unless it consists of money wholly and exclusively laid out or expended for the production of assessable income. It is unnecessary that the assessable income for the production of which the expenditure was made should be that of the given year or accounting period (See *De Bavay's Case* (1)). But, according to the language of the paragraph, the money must be laid out for the production of assessable, not taxable, income. Upon this distinction the commissioner bases a contention that no expenditure is deductible which has for its purpose the reduction or avoidance

(1) (1935) 54 C.L.R., at p. 309.

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of outgoings as distinguished from the gaining of gross income This statement may be literally true, but its application does not necessarily lead to the consequences the commissioner deduces. For it is fallacious, in my opinion, to draw a distinction between the purpose of reducing or avoiding outgoings and the purpose for which the outgoings so to be reduced or avoided are incurred. Thus, in the present case, if attention is confined to the purpose for which the lump sum payment was made to the retiring director, it may be true that it was in order to save his future salary. Indeed, the case stated says that the main object of the directors was to effect a saving of that salary, although at the same time they believed that by abolishing the system of joint control they would increase the efficiency of the company. But it is not correct to look only to the purpose actuating the expenditure in the state of facts in which it was resolved upon. The whole course of the transaction must be regarded. When an agreement was made by the company committing it to an annual expenditure for five years of £1,500 upon the managing director's salary, that obligation was undoubtedly incurred "for the production of assessable income." The company thus undertook an expenditure which, if it had gone on, would have been deductible. The purpose appears to me to govern the entire course of the transaction. On reconsideration, it appeared that the purpose would be better fulfilled by a rearrangement involving an expenditure made in commutation of that undertaken. Why should the original purpose be excluded from view and the immediate purpose alone be considered ? A wide view should be taken of the meaning of sec. 25 (*e*). For it is intended to apply to an infinite variety of sources of income. When the expenditure avoided or reduced has been or would be incurred for the production of income, it appears to me that the substituted expenditure comes fairly within the description money exclusively laid out for the production of income.

In my opinion the retiring allowance is a deductible outgoing. But I do not think that so much of it as was represented by promissory notes payable after 30th June 1931 can be deducted in the assessment for the financial year ending 30th June 1932.

In my opinion the question in the case stated should be answered : Yes, £1,900 thereof.

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McTIERNAN J. I agree that the answer to the question should be as stated in the judgment of the Chief Justice. The assessable income of the company was necessarily gained through the agency of its employees and it follows that the expense of providing and maintaining such an organization is to be attributed to the operation of producing the company's income. The maintenance of this income-earning agency involves its adjustment to conditions which arise such as those mentioned in the stated case. The expense incurred in effecting these adjustments is also to be attributed to the earning of the company's income. Upon the facts appearing in the stated case I think that the expenditure with regard to which the present question arises is within the scope of sec. 23 (1) (*a*). These facts show that the expenditure was incurred to adapt the managerial part of the company's organization for making profits to conditions affecting its business and as such was incidental to its income-earning activities.

The expenditure was made in the relevant accounting period, but it is not necessary that the assessable income for the gaining of which the expenditure was made was income of that period (*De Bavay's Case* (1)).

There is no substance in the contention that the deduction claimed was an outgoing of capital. The only ground on which it was sought to support that contention was that the moneys were capital in the hands of the recipient. Even if that view were correct it would furnish no reason for ascribing to the expenditure the character of a capital payment by the company.

The result aimed at by the company in expending the moneys now in question was to obtain the resignation of the recipient, he having been appointed at an annual salary for a term which had not expired. Although money expended may be within sec. 23 (1) (*a*), it is provided by sec. 25 (*e*) that a deduction shall not in any case be made in respect of money not wholly or exclusively laid out or expended for the production of assessable income. It is true, as contended by the commissioner, that the payment of the compensation resulted in the production of taxable income because it removed the salary formerly payable to the recipient of the compensation

(1) (1935) 54 C.L.R. 295.

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from the list of allowable deductions. But it does not follow that the amount of the compensation itself cannot be allowed as a deduction for the reason that it was not wholly or exclusively laid out or expended for the "production of assessable income." It is a very narrow view of the facts to confine the purpose of the payment of the compensation to the elimination of the salary of its recipient from the expenses of the company. That was a practical consequence, but the fair view on all the facts is that the purpose of such payment was to adjust and reorganise the income-earning agency of the company to meet the conditions which it found affecting its operations. In this view of its purpose the deduction is not prohibited by sec. 25 (*e*).

I agree that the deduction for the year ending 30th June 1932 should be limited to £1,900.

Question answered: Yes, a deduction of £1,900, *part of the said sum of* £2,500. *Case remitted. Costs to be costs in the appeal.*

Solicitors for the appellant, *Salwey & Primrose.*

Solicitor for the respondent, *W. H. Sharwood,* Commonwealth Crown Solicitor.

J. B.