Dist Burgess v FCT (1988) 80 ALR 639

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

Foll Slater v Commissioner of Inland Revenue [1996] 1 NZLR 759

Appl W D & H O Wills (Australia) Pty Ltd v Comr of Taxation (1996) 32 ATR 168

Not Foll Sweetman v Commissioner of Inland Revenue (Fiji) (1996) 34 ATR 209

Appl W D & H O Wills (Australia) Pty Ltd v Comr of Taxation (1996) 65 FCR 298

[HIGH COURT OF AUSTRALIA.]

THE COMMISSIONER OF TAXATION (NEW SOUTH WALES) APPELLANT, . . . APPELLANT;

AND

ASH . . . . RESPONDENT.
RESPONDENT,

ON APPEAL FROM THE SUPREME COURT OF NEW SOUTH WALES.

ASH . . . . APPELLANT;

AND

THE FEDERAL COMMISSIONER OF TAXATION . . . . RESPONDENT.

H. C. OF A. 1938.

SYDNEY, *Nov.* 21, 22; *Dec.* 23.

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

Income Tax (*Cth. and N.S.W.*)—*Assessable income—Deduction—Solicitor—Defalcations by partner—Dissolution of partnership—Bankruptcy of partner—*"*Outgoings* (*not being . . . outgoings in the nature of capital*) *actually incurred in gaining or producing the assessable income*"—*Income Tax Assessment Act* 1922-1930 (*No.* 37 *of* 1922—*No.* 50 *of* 1930), *secs.* 23 (1) (*a*), 25 (*e*)—*Income Tax* (*Management*) *Act* 1928 (*N.S.W.*) (*No.* 35 *of* 1928), *secs.* 19 (1) (*a*), 21 (*d*)—*Prevention and Relief of Unemployment Act* 1930 (*N.S.W.*) (*No.* 34 *of* 1930).

Claims made against a solicitor by reason of the frauds of his former partner, who had been adjudicated bankrupt, were settled by a compromise under which the solicitor agreed to pay a specified sum by annual instalments.

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Held that payments made under the compromise were "outgoings of capital" within the meaning of that phrase in sec. 23 (1) (*a*) of the *Income Tax Assessment Act* 1922-1930 and sec. 19 (1) (*a*) of the *Income Tax* (*Management*) *Act* 1928 (N.S.W.); accordingly they were not deductible under either Act from the assessable income of the solicitor for the years in which they were made.

Decision of the Supreme Court of New South Wales (Full Court): *Commissioner of Taxation* v. *Ash*, (1938) 38 S.R. (N.S.W.) 444; 55 W.N. (N.S.W.) 147, reversed.

Appeal from the Supreme Court of New South Wales.

Commissioner of Taxation (*N.S.W.*) v. *Ash*.—An assessment for unemployment-relief tax for the year ended 30th June 1930 made by the Commissioner of Taxation for New South Wales was objected to by the taxpayer, Goddard William Ash, a solicitor, on the ground that the commissioner had not allowed the deduction from his, the taxpayer's, assessable income of a sum of £500, which sum the taxpayer claimed was a loss incurred by him in respect of the defalcations of a former partner, and was a loss, outgoing and expense actually incurred by him in the production of income.

The commissioner disallowed the objection, whereupon the taxpayer appealed to the board of appeal constituted under the *Income Tax* (*Management*) *Act* 1936 (N.S.W.).

Upon the hearing of the appeal the following facts were admitted: The taxpayer was admitted as a solicitor by the Supreme Court of New South Wales in 1891, and at all times since had practised, and at the date of the appeal was still practising in Sydney as a solicitor. In 1908 the taxpayer took another solicitor into partnership with him in his business as a solicitor, and from 1908 until 1921 the taxpayer carried on business with that other solicitor under a firm name which consisted of the surnames of the two partners. Before 1908 the taxpayer carried on business alone and since 1921 he had again done so. During the existence of the partnership the other partner, at various times, misappropriated moneys of clients, and on 28th February 1921 the partnership was dissolved. The other partner's name was removed from the roll of solicitors on 8th September 1921, and on 12th October 1921 he was made bankrupt. During its existence one F. W. Hughes was a client of the partnership and employed it in the ordinary course of its business as solicitors in connection with many matters. In addition, and during the same period, the partnership was employed as solicitors by four companies. F. W. Hughes was a director of each of these companies. In dealing with those matters the other partner, during the years 1918 to 1920 inclusive, misappropriated moneys paid to him professionally by Hughes and each of the companies referred to above. After the dissolution of the partnership Hughes and the four companies issued legal process against the taxpayer for the recovery of the moneys so misappropriated and in 1924 an agreement was reached between Hughes, the four companies and the taxpayer under which Hughes and those companies were to accept and the taxpayer was to pay in full settlement of all matters in dispute between the parties and arising out of the said misappropriations the sum of £3,500, the sum of £500 being payable in the year ended 30th June 1925, and the balance by annual instalments of £500. The taxpayer did in each and every year after 1924 up to and including the income year the subject of the appeal pay to Hughes the sum of £500 due under the agreement.

The taxpayer stated in evidence that apart from the purchase of books and furniture he had not at any time put any capital into the business, and that the only capital his business had was its goodwill value. The sum of £500 was paid out of his private account.

The board of appeal (i) found as facts : (*a*) the matters admitted ; (*b*) that the obligation to pay the £500 arose by law out of the carrying on of the profession and practice of the taxpayer in partnership, in which practice his then partner had misappropriated clients' money ; (*c*) that the practice of the taxpayer was in the year in question, and still was at the date of the appeal, carried on as a source of the assessable income of the taxpayer ; and (*d*) that the payment was not an outgoing in the nature of an outgoing of capital ; and (ii) allowed the deduction claimed by the taxpayer.

An appeal by the Commissioner of Taxation under the provisions of sec. 249 of the *Income Tax (Management) Act* 1936 (N.S.W.) from the decision of the board of appeal was dismissed, by majority, by the Full Court of the Supreme Court of New South Wales : *Commissioner of Taxation* v. *Ash* (1).

(1) (1938) 38 S.R. (N.S.W.) 444 ; 55 W.N. (N.S.W.) 147.

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From that decision the Commissioner of Taxation appealed, by special leave, to the High Court.

APPEAL from the board of review.

Ash v. *The Federal Commissioner of Taxation.*—An objection was lodged by the taxpayer, Goddard William Ash, against an assessment for income tax made under the *Income Tax Assessment Act* 1922-1930 by the Federal Commissioner of Taxation in respect of income derived by the taxpayer during the year ended 30th June 1930.

The taxpayer complained that a deduction from his assessable income of the sum of £500, particulars of which sum are shown above, had not been allowed.

The commissioner disallowed the objection, and his decision was upheld by the board of review.

An appeal by the taxpayer to the High Court from the decision of the board of review was referred under sec. 18 of the *Judiciary Act* 1903-1937 by *McTiernan* J. to the Full Court.

The two appeals were heard together.

The court was informed that the parties had agreed that the evidence given before the board of appeal should be accepted as the evidence for the purposes of both appeals.

Hooton, for the Commissioner of Taxation (N.S.W.) and the Federal Commissioner of Taxation. The deduction was not allowed under sec. 19 (1) (*a*) of the *Income Tax* (*Management*) *Act* of New South Wales, or under sec. 23 (1) (*a*) of the *Income Tax Assessment Act*. The payment was in the nature of a payment of capital. The taxpayer became severally liable under sec. 11 (*a*) of the *Partnership Act* 1892 (N.S.W.) to make good the loss caused by his defaulting partner. The payment has not the characteristics of revenue expenditure, but it has the characteristics of capital expenditure; it is, within the meaning of both sections, a payment in the nature of a capital payment: an outgoing in the nature of capital. Defalcations by partners are not ordinary incidents of business, particularly of a business such as that carried on by a solicitor.

[DIXON J. referred to *Toohey's Ltd.* v. *Commissioner of Taxation* (*N.S.W.*) (1).]

(1) (1922) 22 S.R. (N.S.W.) 432, at pp. 443, 444.

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[LATHAM C.J. referred to *Ward & Co. Ltd.* v. *Commissioner of Taxes* (1).]

The decision of the court in *Herald & Weekly Times Ltd.* v. *Federal Commissioner of Taxation* (2) turned largely on the finding of fact that meeting claims for libel was almost an inevitable and ordinary incident of the business of a newspaper proprietor. The payment made by the taxpayer is analogous to the payments under consideration in *Inland Revenue Commissioners* v. *von Glehn* (3) and *Inland Revenue Commissioners* v. *Warnes & Co. Ltd.* (4). The payment made by the taxpayer was of an extraordinary character and was not reasonably or necessarily incidental to the carrying on of his practice as a solicitor. The expenditure was not incurred in gaining or producing the assessable income within the meaning of sec. 19 (1) (*a*) or sec. 23 (1) (*a*) (*Strong & Co. Ltd.* v. *Woodifield* (5)). It had no relation to the assessable income of the year in respect of which the return was made (*Amalgamated Zinc* (*De Bavay's*) *Ltd.* v. *Federal Commissioner of Taxation* (6)). The liability was incurred during the partnership and was met after the partnership was dissolved. The expenditure was not wholly and exclusively laid out or expended for the production of assessable income : see sec. 21 (*d*) of the *Income Tax* (*Management*) *Act* (*N.S.W.*) and sec. 25 (*e*) of the *Income Tax Assessment Act* 1922-1930 (*Strong & Co. Ltd.* v. *Woodifield* (7)).

[DIXON J. referred to *Fry* v. *Salisbury House Estate Ltd.*; *Jones* v. *City of London Property Co.* (8).]

The decision in *Herald & Weekly Times Ltd.* v. *Federal Commissioner of Taxation* (9) indicates the limit of the law expressed in sec. 21 (*d*) and sec. 25 (*e*). The meaning of those sections is shown in *Ward & Co. Ltd.* v. *Commissioner of Taxes* (10). The word " the " appears before the words " assessable income " in sec. 21 (*d*) but does not appear before those words in sec. 25 (*e*). The effect of the word " the " in that collocation was considered in *Federal Commis-*

(1) (1923) A.C. 145.
(2) (1932) 48 C.L.R. 113.
(3) (1920) 2 K.B. 553.
(4) (1919) 2 K.B. 444.
(5) (1905) 2 K.B. 350, at pp. 354, 356 ; (1906) A.C. 448, at p. 452.
(6) (1935) 54 C.L.R. 295, at pp. 303, 309.
(7) (1906) A.C., at pp. 452, 453.
(8) (1930) A.C. 432.
(9) (1932) 48 C.L.R. 113.
(10) (1923) A.C., at pp. 149, 150.

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sioner of Taxation v. *Gordon* (1); *Amalgamated Zinc* (*De Bavay's*) *Ltd.* v. *Federal Commissioner of Taxation* (2); *W. Nevill & Co. Ltd.* v. *Federal Commissioner of Taxation* (3). In *Income Tax Commissioners* v. *Basant Rai Takhat Singh* (4) the expression "such income" was held to refer to the income under assessment. The expression "the assessable income" in sec. 21 (*d*) and the expression "assessable income" in sec. 25 (*e*) refer to the assessable income of the year or accounting period in question. No expenditure may be deducted which has not been wholly and exclusively laid out or expended for the purpose of producing that particular income. Here the position was that the expenditure had no relation whatsoever to the assessable income of the year in question (*Roebank Printing Co. Ltd.* v. *Inland Revenue Commissioners* (5)).

[DIXON J. referred to *New Zealand Flax Investments Ltd.* v. *Federal Commissioner of Taxation* (6).]

The expression "actually incurred" was considered in *Commissioner of Taxation* v. *Manufacturers' Mutual Insurance Ltd.* (7).

Maughan K.C. (with him *Barton Maughan*), for the taxpayer. The word "outgoings" in sec. 19 (1) (*a*) is a comprehensive term much wider than the words "expenses" or "payments." The words in that sub-section mean all losses and outgoings actually incurred in the course of gaining or producing assessable income (*Amalgamated Zinc* (*De Bavay's*) *Ltd.* v. *Federal Commissioner of Taxation* (8); *W. Nevill & Co. Ltd.* v. *Federal Commissioner of Taxation* (9)). The defalcations by his partner, the discharge of the liability and the retention of the client were all done in the course of the practice by the taxpayer of his profession of a solicitor and the earning of the assessable income. The retention of the client was both the potential source of income and the cause of liability (*Herald & Weekly Times Ltd.* v. *Federal Commissioner of Taxation* (10)). A voluntary payment, if advantageous to the business, is a

(1) (1930) 43 C.L.R. 456, at p. 463.
(2) (1935) 54 C.L.R., at pp. 303, 307, 309.
(3) (1937) 56 C.L.R. 290, at pp. 300, 305.
(4) (1933) L.R. 60 Ind. App. 307.
(5) (1928) 13 Tax Cas. 864, at pp. 873, 874; (1928) S.C. 701, at p. 706.
(6) (1938) 61 C.L.R. 179.
(7) (1931) 31 S.R. (N.S.W.) 575; 48 W.N. (N.S.W.) 215.
(8) (1935) 54 C.L.R., at pp. 303, 309
(9) (1937) 56 C.L.R., at p. 305.
(10) (1932) 48 C.L.R., at p. 121.

deductible outgoing (*Federal Commissioner of Taxation* v. *Gordon* (1)). The *ratio decidendi* in *De Bavay's Case* (2) was that the business in respect of which the payments were made had ceased to exist. So far as the deduction made under sec. 19 (1) (*a*) of the State Act is concerned it was found as a fact that the payment was a loss not in the nature of an outgoing of capital. No appeal lies from that finding. The payment does not reveal any of the characteristics of capital expenditure. With regard to a professional man it is hard to visualize anything as loss of capital. In the circumstances the payment is an income expenditure (*Mitchell* v. *B. W. Noble Ltd.* (3); *Anglo-Persian Oil Co. Ltd.* v. *Dale* (4)). The evidence shows that the payment was in fact made out of the taxpayer's profits for the relevant year. The payment was an outgoing not in the nature of capital and was expenditure actually incurred in the course of gaining or producing the assessable income. Sec. 21 (*d*) is irrelevant. If that section were given its literal and grammatical meaning, and the comprehensive meaning attributed to it by the commissioner, the structure of sec. 19, the positive deduction section, would be almost destroyed. The emphasis in sec. 21 (*d*) is upon the words "wholly or exclusively." It is intended to exclude expenditure which is only partly laid out or expended in the production of assessable income, that is, that a deduction shall not be made in respect of money laid out or expended in production of assessable income unless it is wholly and exclusively laid out or expended. The words "the assessable income" mean the assessable income of the taxpayer's business and not the income for the particular year under assessment (*Ward & Co. Ltd.* v. *Commissioner of Taxes* (5)); the business of the taxpayer was carried on as a continuous business (*Herald & Weekly Times Ltd.* v. *Federal Commissioner of Taxation* (6); *De Bavay's Case* (2); *W. Nevill & Co. Ltd.* v. *Federal Commissioner of Taxation* (7)).

Hooton, in reply. The source of the liability to the taxpayer was the wrongful acts of his partner. A question involving the construction of sec. 19 (1) (*a*), in which the expression "in the nature of losses

(1) (1930) 43 C.L.R. 456.
(2) (1935) 54 C.L.R. 295.
(3) (1927) 1 K.B. 719, at pp. 728, 734, 740.
(4) (1932) 1 K.B. 124, at pp. 137-139, 141.
(5) (1923) A.C., at pp. 148-150.
(6) (1932) 48 C.L.R. 113.
(7) (1937) 56 C.L.R. 290.

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and outgoings of capital" occurs, is a mixed question of fact and law. There was no material upon which the board of appeal could make a finding as a question of fact (*Federal Commissioner of Taxation* v. *Munro* (1); *Ruhamah Property Co. Ltd.* v. *Federal Commissioner of Taxation* (2); *Colonial Mutual Life Assurance Society Ltd.* v. *Federal Commissioner of Taxation* (3)). Having regard to the particular matters referred to in sec. 19, sec. 21 (*d*) should be regarded as a general section dealing with the expenditure of money. The interpretation sought to be placed by the taxpayer upon sec. 21 (*d*) and sec. 25 (*e*) is unwarranted (*Stockvis* v. *Federal Commissioner of Taxation* (4)). The expression "the assessable income" means the income of the particular year or accounting period under review.

Cur. adv. vult.

Dec. 23.

The following written judgments were delivered:—

Latham C.J. The question which arises upon these appeals is whether a solicitor who has made payments in settlement of claims made against him by clients by reason of his bankrupt partner's frauds is entitled to deduct the payments from his income returned under the Federal *Income Tax Assessment Act* 1922-1930 and the *Income Tax (Management) Act* 1928 (N.S.W.).

A Federal board of review disallowed the deduction under the Federal Act and the taxpayer has appealed to this court. The question under State law arises directly under the *Prevention and Relief of Unemployment Act* 1930 (N.S.W.), which incorporates the *Income Tax (Management) Act* 1928 (N.S.W.). A State board of appeal decided in favour of the taxpayer. The Full Court of the Supreme Court of New South Wales (by a majority, *Davidson* and *Stephen* JJ., *Owen* J. dissenting) (5) dismissed an appeal and the State Commissioner of Taxation has appealed by special leave to this court.

The taxpayer, Goddard William Ash, has practised as a solicitor since 1891. In 1908 he took into partnership a partner who remained

(1) (1926) 38 C.L.R. 153, at p. 196.
(2) (1928) 41 C.L.R. 148, at p. 151.
(3) (1933) 49 C.L.R. 171, at p. 175.
(4) (1930) 1 A.T.D. 9, at p. 11.
(5) (1938) 38 S.R. (N.S.W.) 444; 55 W.N. (N.S.W.) 147

a member of the firm until 1921. During the years 1918 to 1920 the partner fraudulently procured clients to make overpayments to him in respect of various outgoings, such as counsels' fees, payments under contracts of sale, stamp duties, &c. The frauds were discovered, the partnership was dissolved, the partner was struck off the roll of solicitors and was made bankrupt. One group of clients claimed in an action against Mr. Ash the repayment of over £11,000 which the partner had received from them and had not accounted for. The action was settled by a compromise under which Mr. Ash agreed to pay £3,500 by annual instalments of £500. The appeals relate to a payment of £500 made in the year 1929-1930.

The Federal Act, sec. 23 (1) (*a*), provides that 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."

An identical deduction is allowed by par. 1 (*a*) of sec. 19 of the State Act.

Sec. 25 of the Federal Act provides that " a deduction shall not, in any case, be made in respect of . . . (*e*) money not wholly and exclusively laid out or expended for the production of assessable income."

The corresponding provision in the State Act (sec. 21 (*d*)) is identical except that the word " or " is substituted for " and " after " wholly " and that the word " the " appears before " assessable income."

In the case of the Federal Act attention has been directed to the absence of the word " the " in sec. 25 (*e*). This omission or absence, it has been said, results in the allowance of deductions being more generous than would otherwise be the case. The reference to " assessable income " rather than to " the assessable income " suggests that a deduction is permissible if it is related in the relevant manner to any assessable income—that is, to assessable income of any year, not necessarily of the year under assessment : See *Amalgamated Zinc* (*De Bavay's*) *Ltd.* v. *Federal Commissioner of Taxation* (1) ; *W. Nevill & Co. Ltd.* v. *Federal Commissioner of Taxation* (2).

(1) (1935) 54 C.L.R., at pp. 307, 309. (2) (1937) 56 C.L.R., at p. 305.

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But, in my opinion, for reasons which will be stated, it is not necessary to consider this question in this case.

The taxpayer paid the money pursuant to the compromise of the action. He made the compromise because he was otherwise liable to pay a larger amount. He was so liable because he had the misfortune to have a dishonest partner in the business from which he derived his income. The liability fell upon him because it was a liability of the firm of which he was a member (*Partnership Act* 1892 (N.S.W.), secs. 11 (*a*), 12) and because his partner became bankrupt. The taxpayer claims that the deduction is permitted by sec. 23 (1) (*a*) of the Federal Act and by sec. 19 (1) (*a*) of the State Act, and that it is not prohibited by sec. 25 (*e*) of the Federal Act or sec. 21 (*d*) of the State Act.

The first question to be considered is whether the sum is a loss or outgoing (not being in the nature of a loss or outgoing of capital) actually incurred in gaining or producing assessable income.

If this question is answered in the negative it will not be necessary to refer to any distinction between "assessable income" and "the assessable income" in the relevant sections; nor will it be necessary to inquire whether the money was wholly or exclusively laid out or expended for the production of any assessable income.

The payment made by the taxpayer did not itself produce income. But a payment may be a step towards the production of income. It is not necessary, in order to justify a deduction under the Federal sec. 23 (1) (*a*) or the State sec. 19 (1) (*a*), to show a connection between an outgoing and any particular item of income. Payment of weekly wages to a salesman cannot be allocated to particular items of goods sold by him, but moneys paid for wages are clearly a proper deduction by a shopkeeper. If the payment is made in the course of gaining or producing the assessable income and is not excluded as a loss or outgoing of capital or by some specific provision of the Act, it will be an allowable deduction: See per *Ferguson* J. in *Toohey's Ltd.* v. *Commissioner of Taxation* (*N.S.W.*) (1).

But did this payment have any relation to gaining or producing income? In one sense every business payment has such a relation. If a manufacturer builds a factory for his own use, he does not do

(1) (1922) 22 S.R. (N.S.W.), at p. 440.

so for the mere pleasure of owning a factory. He spends the money for building in order to earn income by the use of the factory. But such an expenditure is plainly a capital expenditure and cannot be deducted. There are many other expenditures which it is wise to make, but which cannot be deducted for income tax purposes. They are incurred in gaining or improving a capital asset or in discharging a capital liability.

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In their reasons for judgment the learned judges of the Supreme Court dealt carefully with the question of the connection of the payment with the taxpayer's business and with the question of the possibility of allowing the deduction in the particular year in question. Less attention was directed to the question whether the loss or outgoing was of a capital nature. It may be conceded that the necessity for making the payment arose out of the carrying on of the profession of the taxpayer, that it was a proper expenditure, and that he paid the money out of his income. But these facts do not make it possible to determine whether or not the payment was in the nature of a loss or outgoing of capital. This, in my opinion, is the important question in the present case.

An expenditure which is directly associated with the daily requirements or exigencies of a business will be an allowable deduction. But such a statement as this cannot be regarded as exhaustive. The line is sometimes difficult to draw : See the cases cited in *Anglo-Persian Oil Co. Ltd.* v. *Dale* (1). A payment made to secure a re-adjustment or cancellation of current salaries in a business may be a proper deduction (*W. Nevill & Co. Ltd.* v. *Federal Commissioner of Taxation* (2); *Mitchell* v. *B. W. Noble Ltd.* (3)) while a large-scale payment affecting the whole conduct of a business, even though it is a payment relating to adjustment of contractual rights, may be a capital expenditure (*Van Den Berghs Ltd.* v. *Clark* (4)). When it is found as a fact that payments in respect of claims for libel are regular and almost unavoidable incidents of the business of publishing a newspaper, such payments can be deducted under the provisions mentioned (*Herald & Weekly Times Ltd.* v. *Federal Commissioner of Taxation* (5)). Thus, purloinings by office boys and thefts by shop

(1) (1932) 1 K.B., at pp. 136, 137.
(2) (1937) 56 C.L.R. 290.
(3) (1927) 1 K.B. 719.
(4) (1935) A.C. 431.
(5) (1932) 48 C.L.R. 113.

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employees should, prima facie, be allowed as deductions. They may be shown to be incidental to, and perhaps inevitable in, the operations which produce income.

But the case is different when income is actually received and then misapplied by the proprietor of a business or a person in the position of such a proprietor, as, for example, the manager of a company. In *Curtis* v. *J. & G. Oldfield Ltd.* (1) a limited company sought to deduct from its profits a bad debt consisting of the amount of defalcations by the late manager of the company. *Rowlatt* J. said :—" It was true that if a person, in conducting a business, had to employ subordinates, and owing to the negligence or dishonesty of an employee some of the receipts did not find their way into the accounts, that would be a loss connected with and arising out of the trade, and could be deducted. But that was not the position in the present case. Mr. Oldfield was the managing director, and in charge of the whole business of the company. There was no evidence that the loss was a loss in trade. All that was known was that Mr. Oldfield made away with profits which had been paid over to the company, and this he was able to do by virtue of the position which he held " (2). The deduction claimed was disallowed. If the result of the defalcations had been that the company had paid money to persons who had been defrauded and a deduction had been claimed in respect of such payment, the case would have been more similar to the present case. But the principle upon which the case was decided appears to me to be applicable to the present case. The taxpayer's partner, acting within his authority as a partner, received moneys as a principal for the firm. If he had been honest the firm would have repaid the moneys as soon as what, upon the hypothesis of honesty, would have been a mistake, was discovered. This, by reason of his dishonesty, did not happen. The moneys were misappropriated by a partner who was a principal in the business of the firm. That misappropriation created a liability of the firm to the persons defrauded. The misfortune arose from acts of the partner in carrying on the profit-earning business. But the position would have been the same, in all relevant particulars, if business premises owned by the firm had been destroyed by fire. Such a loss

(1) (1925) 41 T.L.R. 373.

(2) (1925) 41 T.L.R., at p. 374.

is a business risk, just as fraud of a partner is a business risk. But the loss is a capital loss and expenditure made for the purpose of meeting or retrieving the loss is a capital expenditure.

Thus I am of opinion that the payments made to the defrauded clients were made to discharge a capital liability. They were "in the nature of outgoings of capital." The ultimate purpose of the payments may have been to preserve the credit of the taxpayer and so to maintain the business as a profit-earning enterprise. But this feature of the payments does not deprive them of their capital nature.

I am therefore of opinion that the appeal of the State Commissioner of Taxation should be allowed. In accordance with the undertaking given when he obtained special leave to appeal, he should pay the costs of the appeal.

The appeal of the taxpayer in the case under the Federal Act must be dismissed. Normally it would be dismissed with costs to be taxed in the usual manner. But the State Commissioner of Taxation and the Federal Commissioner of Taxation have, very properly, appeared by the same counsel. The whole of the argument upon the appeals applied equally to both appeals, which were heard together. The State Commissioner must, in the other appeal, pay the costs of the taxpayer. While the appeal under the Federal Act must be dismissed with costs to be paid by the taxpayer, there should, in my opinion, be excluded from such costs all items to which the State Commissioner of Taxation in the other appeal would have been entitled if in that appeal an order for payment of costs to him had been made.

Rich J. These matters were heard together. One is an appeal by the Commissioner of Taxation from a judgment of the Supreme Court of New South Wales, which dismissed an appeal from a decision of the board of appeal upholding the claim of the taxpayer to be allowed a deduction from his assessable income under the provisions of the *Income Tax (Management) Act* 1928 (N.S.W.). The other is an appeal from the board of review under the provisions of the Federal *Income Tax Assessment Act* 1922-1930, argued at the direction of *McTiernan* J. before the Full Court.

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The facts are already in statement and I need not repeat them. The question which emerges from the facts is the same in each case. The relevant parts in sec. 19 (1) (*a*) of the New South Wales Act and sec. 23 (1) (*a*) of the Federal Act are expressed in the same terms. For the purposes of this judgment I pass over the difference in language of sec. 21 (*d*) of the New South Wales Act and sec. 25 (*e*) of the Commonwealth Act. The question concerns the liability of the taxpayer, who is a solicitor, to make good to the clients of the firm the ravages of a fraudulent partner. Although perfectly innocent himself the taxpayer was obliged to undertake the burden of making good the claims of a client or a set of connected clients from whom his partner had obtained large sums by fraud. By a compromise of an action brought against him in 1925 the taxpayer agreed to pay £3,500 in annual instalments of £500. In the twelve months ending 30th June 1930 he paid one of these instalments. In returning his assessable income for the purposes of Federal and State taxation he claimed to deduct this amount as a loss or outgoing in production of the assessable income. The Federal and State commissioners united in disallowing this deduction. The taxpayer appealed to the State board of appeal and the Federal board of review. The first took the view that the deduction was allowable; the second that it was not. The ground on which the State board held that the deduction was allowable appears from their findings of fact which, after omitting a reference to certain admissions, are as follows :—" We find as facts : (*b*) that the obligation to pay the £500 arose by law out of the carrying on of the profession and practice of the appellant in partnership, in which practice his then partner had misappropriated clients' money ; (*c*) that the practice of the appellant was in the year in question and still is carried on as a source of the assessable income of the appellant ; (*d*) that the payment was not an outgoing in the nature of an outgoing of capital."

The reasons of the board of review for disallowing the deduction are given in the following extract :—" The claim as to the item of £500 must also be disallowed. This amount, we think, was an outgoing of capital. It represented the final payment in connection with a liability which arose through the misappropriations of the taxpayer's former partner. It was a loss incurred by the partnership

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and had to be met out of capital. The liability in the first place rested on the fraudulent partner and was transferred to the taxpayer because of his bankruptcy. Apart from any considerations arising under partnership law, we have no doubt that the claim is inadmissible under the *Income Tax Assessment Act.* The payment of £500 was entirely independent of the production of assessable income. The obligation to pay would have remained on the taxpayer whether he continued to practise as a solicitor or not." The Supreme Court (*Davidson* and *Stephen* JJ., *Owen* J. dissenting) (1) affirmed the decision of the State board of appeal.

The case bears little resemblance to any of the authorities which have been cited. The defalcations of a partner appear to me to stand in a different position from the petty larcenies of servants and the leakages through carelessness or dishonesty to which the revenues of most profit-earning organizations are exposed. There is no difficulty in understanding the view that losses or outgoings incurred as an expedient aid to the more satisfactory working of an undertaking over a considerable interval of time should be allowed as deductions notwithstanding that no immediate, direct or tangible result can be reflected in revenue. This court has more than once acted upon such a view. There is no difficulty in understanding the view that involuntary outgoings and unforeseen or unavoidable losses should be allowed as deductions when they represent that kind of casualty, mischance or misfortune which is a natural or recognized incident of a particular trade or business the profits of which are in question. These are characteristic incidents of the systematic exercise of a trade or the pursuit of a vocation. But here we have an annual payment made for the purpose, in the colloquial phrase, of working off a *damnosa haereditas* of the taxpayer's dead partnership. It has no connection with the present practice of his profession. It arises simply from the misfortune that he admitted a dishonest man into partnership with him. To my mind it is impossible to sustain the case which Mr. *Maughan* endeavoured to make on behalf of the taxpayer that the annual payments were losses or outgoings incident to the continuous practice of the taxpayer's profession because the partnership was merely a normal

(1) (1938) 38 S.R. (N.S.W.) 444 ; 55 W.N. (N.S.W.) 147.

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device for increasing the earnings of the practice. You cannot treat the formation of a partnership as if it were no more than the employment of a clerk nor the depredations of a partner as if they were the peculations of an office boy. The taxpayer's practice of his profession cannot be treated as a continuous and systematic undertaking organized for the production of income with a large staff of people and a mass of circulating capital. Payments to replace losses caused by dishonesty or wrongdoing of servants belonging to such an undertaking are naturally regarded as a debit to the profit and loss account of the year in which they are actually made. The taxpayer's profession is now practised by his own personal exertion aided by such a staff as is necessary. He did not employ a partner as part of the staff. The partner was a proprietor, and whilst all must sympathize with the taxpayer and deplore the wrong done to him by this partner it is impossible to treat that wrong as a characteristic incident of the carrying on of his profession the consequences of which are to be reflected in the profit and loss account until they are exhausted.

DIXON J. These two cases turn upon the same set of facts. The question in each is whether a payment made by the taxpayer forms an allowable deduction from his assessable income for the year in which the payment was made. In the one case the assessment is for State unemployment-relief tax, in the other for Federal income tax. Except in so far as differences in legislative expression affect the cases, they raise a common question.

The payment which the taxpayer claims to deduct is an instalment of a sum for which he became liable in an antecedent period. He is a solicitor who has had the misfortune to suffer vicariously for the dishonesty of a partner. His partner misappropriated moneys belonging to clients of the firm or otherwise defrauded them, and, as a consequence, the taxpayer was saddled with the liability on account of which he made the payment that he now seeks to deduct. He himself had carried on a successful and honourable practice for many years when in an ill hour he admitted his managing clerk into partnership. The partnership was formed in 1908. Until the end of 1920, when the taxpayer, while travelling abroad, learned of the discovery of his partner's dishonesty, the firm, to all appearances, prospered. Among the clients of the firm whose business was looked after by the partner rather than by the taxpayer was one who was the substantial proprietor of a number of companies. The frauds of the partner upon this client or his companies involved a considerable sum of money. They were perpetrated during the years 1918, 1919 and 1920. The consequence was that the taxpayer found himself faced with a large claim from the client in question and his companies. At length an action was brought against the taxpayer in which £11,194 was claimed. In 1925 a compromise was effected. Under the compromise the taxpayer became liable to pay a sum of £3,500, £500 down and the balance by instalments of £500 each payable annually on 1st December 1925 to 1930. He also undertook to secure the future instalments, amounting to £3,000, by mortgages of certain real property.

The present cases are concerned with the year of income ended 30th June 1930, during which the taxpayer paid one of the annual instalments of £500. The question is whether he is entitled to deduct it from his assessable income for that year for the purpose of calculating his taxable income. In respect of income of that period State unemployment-relief tax was assessed under the provisions of the *Income Tax (Management) Act* 1928 (N.S.W.) and Federal income tax under those of the *Income Tax Assessment Act* 1922-1930. The material part of sec. 19 (1) (*a*) of the State Act is in the same terms as the material part of sec. 23 (1) (*a*) of the Commonwealth Act. They provide that, in calculating the taxable income of a taxpayer, there shall be deducted from the assessable income 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. Sec. 21 (*d*) of the State Act is the counterpart of sec. 25 (*e*) of the Commonwealth Act. They differ in respect of two words, "or" and "the." The Commonwealth provision forbids a deduction in respect of money not wholly *and* exclusively laid out or expended for the production of assessable income; the State, a deduction in respect of money not wholly *or* exclusively laid out or expended for the production of *the* assessable income. The absence of the definite article before

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"assessable income" is a matter which on former occasions I have treated as material to the interpretation of the Commonwealth enactment (*Amalgamated Zinc (De Bavay's) Ltd.* v. *Federal Commissioner of Taxation* (1); *W. Nevill & Co. Ltd.* v. *Federal Commissioner of Taxation* (2)), and in the present case in the Supreme Court *Owen* J. (3) based his dissenting opinion that the deduction was not allowable upon an interpretation of sec. 21 (*d*) of the State Act determined by the definite article, a construction which confined deductions for money laid out or expended to money laid out or expended for the purpose of producing the assessable income of the particular accounting period under assessment. To avoid this result, which may be considered to produce a harsh and unreasonable exclusion of many deductions which would be made as of course in an account constructed upon commercial principles, counsel for the taxpayer suggested that both the State sec. 21 (*d*) and the Federal sec. 25 (*e*) ought to be understood as meaning nothing more than that if a claim is made to deduct money as laid out or expended for the production of assessable income, or *the* assessable income, it shall not be allowed unless the money is wholly and exclusively so laid out and expended. The construction contended for is, in other words, one by which the sole office of the clause is to exclude sums laid out or expended for the purpose stated but in part only. This view of the provision so far has not been adopted in any of the many judicial discussions dealing with this very difficult provision, but it does not follow that it is unsustainable. The conclusion which I have reached does not depend upon its correctness nor upon the presence or absence of the definite article before the word assessable.

In my opinion the deduction is not allowable because of its nature. In the first place, it is evident that the actual payment of £500 was made only because of the existence of the antecedent liability. Once the compromise was made, the amount agreed upon became a personal liability of the taxpayer secured over certain of his capital assets, and its discharge became a matter quite independent of his continuing to practise and quite unconnected with the earning of future income. It was simply a liability sustained and fixed in an

(1) (1935) 54 C.L.R., at pp. 309, 310. (2) (1937) 56 C.L.R., at pp. 305, 306.
(3) (1938) 38 S.R. (N.S.W.), at p. 465.

earlier year. The claim to deduct it must, therefore, rest on the nature of the liability as determined by its origin. In considering its character, it is important to remember that we are dealing with the liability of the taxpayer as an individual. If the question were whether the defalcations formed a proper debit against revenue in making up the accounts of the former partnership, it must clearly be answered in the negative. For the liability of the firm, considered as an independent accounting entity, arose entirely from the misapplication of the funds by one of the members by whom it was constituted. If a proprietor of a business converts its funds to his own use or uses the opportunities the business affords to defraud its clients or customers, his resulting liability cannot be considered an outgoing of the business, still less an outgoing on revenue account. The determining considerations must therefore be the source and nature of the taxpayer's liability for the frauds of the partner. His liability rests, of course, upon the legal responsibility of every partner for the acts of another partner done in the course of his authority as a partner. The responsibility springs out of the relationship, which involves the principles of agency. Recognizing this fact, the taxpayer's counsel put his case on grounds akin to those which would support the allowance of losses and outgoings caused by the pilferings, misconduct or frauds committed by servants whose employment is a necessary part of any organized business and the risk of whose dishonesty may be regarded as incidental thereto. The contention represents the taxpayer as conducting a continuous practice throughout his professional career and as being impelled to secure the services of a partner as a means of increasing the income derived from his practice. Then, it is said, the partner, acting under the authority which for the purpose of producing assessable income the taxpayer had conferred upon him, proceeded to obtain the particular client for the firm and so found the opportunity to commit the fraud. In this way it is sought to stamp upon the act of the taxpayer from which his liability springs the characteristics of a thing done in the course of and for the purpose of producing assessable income. The ground upon which expenditure to meet any unintended and undesired liability is allowed as a deduction from assessable income and is allowed in a given year notwithstanding

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that the liability was incurred in a prior accounting period is that the liability is a natural or recognized consequence or incident of the regular and continuous exercise of a trade or conduct of a business or pursuit of a vocation. On this ground the incurring of the liability is treated as something done in the course of producing the income and as falling within the general purpose of producing income with which the acts out of which it springs are done. If it is an incident which regularly occurs or may be normally looked for, the payment which discharges the liability is or may be properly included in the account for the period in which it is made, rather than that for the period in which the liability is incurred. Both considerations are illustrated by the payments made for damages and costs for libel by a newspaper proprietor which found that claims for libel were a regular and unavoidable incident of its business. The payments were held to be allowable deductions from the assessable income derived from the publication of newspapers and to be properly deducted in the period when they were made (*Herald & Weekly Times Ltd.* v. *Federal Commissioner of Taxation* (1)).

Where the reason for allowing a deduction is that it is a normal or recurrent expenditure or an expenditure which is fairly incident to the carrying on of the business, it is evident that it can seldom be associated with any particular item on the revenue side against which to set it, and, as the ground of its allowance is that it is an incident or accident, something concomitant to the conduct of the business, it follows that to deduct it in the year when it falls to be met is consistent with the reason for deducting it and conforms with business principles. Thus, in *W. Nevill & Co. Ltd.* v. *Federal Commissioner of Taxation* (2), where, although the matter was not argued, the court found it necessary to say whether the payments made to the retiring manager should be deducted in the period when they were agreed upon or that in which they were made, it was considered that the deductions should be made from the assessable income of the periods of account in which the payments were made. But, in my opinion, none of these considerations is applicable to the present case. The establishment of the partnership formed no part of the regular carrying on of the business or practice of the taxpayer as

(1) (1932) 48 C.L.R. 113.

(2) (1937) 56 C.L.R. 290.

a solicitor. It was a transaction which concerned the ownership of the business or practice considered as an organized undertaking. It was directed, no doubt, to the strengthening and enlargement of the business and in that sense to the increase of the income of each partner. There is a clear distinction between a transaction by which, on the one hand, an organization of partners is formed or set up to co-operate in the ownership and conduct of an existing business and, on the other hand, an actual carrying on of the business for the purpose of earning profits. The distinction presents a strong analogy to the distinction between a transaction on account of capital and a transaction on account of revenue. Both descriptions of transactions may be said to be directed to the production of assessable income. But the expenditure connected with the first is not deductible. It is true that the reason lies in the distinction drawn by the statute between outgoings on account of capital and those on account of income. But that distinction itself is concerned in a great measure with the difference between the flow of expenditure necessary to produce a flow of income and expenditure which, however it may be called, falls outside that category. Expenditure falling outside that category is usually represented by some asset or advantage of a fixed, or, at any rate, continuing, nature, but it may amount to nothing but a loss or depletion of value or wealth.

In my opinion the loss inflicted upon the taxpayer by his fraudulent partner takes no place in the subsequent carrying on of his practice. It was simply a loss or depletion of his general resources as a result of his undertaking the risk of such a liability when by entering into partnership each partner armed the other with an authority under which he might impose liabilities upon him.

In my opinion the appeal from the Supreme Court of New South Wales should be allowed and the order of the Supreme Court and the decision of the State board of appeal should be discharged and the assessment of the commissioner affirmed. The appellant commissioner, pursuant to his undertaking given when special leave was obtained, should pay the respondent's costs of the appeal to this court. As this is an appeal by special leave which was granted because of the general importance of the case, I think we should make no order in respect of the costs below.

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The appeal of the taxpayer from the Federal board of review should be dismissed.

A difficulty arises in connection with the costs of the two appeals. They are separate proceedings, but they were argued together, and the respective commissioners were represented by the same counsel. No order we make in favour of the Federal commissioner should be allowed to operate so as to detract from the effect of the undertaking given by the State commissioner to pay the costs of his appeal in any event. Yet there is no ground for depriving the Federal commissioner of his costs. It is possible that some of the costs of the hearing may be chargeable to both commissioners, that is to say, if the costs of neither of them were recovered from the opposite party and if for any reason it were found necessary to determine their responsibility for the costs to their own legal representatives, they would both be chargeable. A special direction should be given so as to prevent the Federal commissioner recovering under the order for costs made in his favour against the taxpayer any costs falling under this category. I think that the purpose would be achieved by adding to an order that the taxpayer should pay the Federal commissioner's costs of his appeal to this court, a special direction that, in the taxation of such costs, no costs or fees are to be allowed to the Federal commissioner with which the State commissioner may be chargeable or which he might have recovered under an order for costs in his favour had one been made, and that such costs or fees are not to be allowed, whether they might have been recovered on a taxation as between party and party or only upon a taxation as between solicitor and client.

McTiernan J. I am of the same opinion.

Appeal from the Supreme Court of New South Wales allowed. Decision of the State board of appeal discharged and assessment of the Commissioner of Taxation of New South Wales affirmed. Commissioner of Taxation of New South Wales to pay respondent's costs of appeal to Supreme Court and, pursuant to his undertaking given when special leave to appeal was obtained, to pay respondent's costs of appeal from the Supreme Court to *this court. Appeal of the taxpayer from the Federal board of review dismissed with costs, subject to the special direction that, in the taxation of such costs, no costs or fees are to be allowed to the Federal commissioner with which the State commissioner may be chargeable or which he might have recovered under an order for costs made in his favour had one been made and that such costs or fees are not to be allowed whether they might have been recovered on a taxation as between party and party, or only upon a taxation as between solicitor and client.*

Solicitor for the Commissioner of Taxation (N.S.W.), *J. E. Clark*, Crown Solicitor for New South Wales.

Solicitor for the Federal Commissioner of Taxation, *H. F. E. Whitlam*, Commonwealth Crown Solicitor.

Solicitor for the taxpayer, *G. W. Ash*.

J. B.