[HIGH COURT OF AUSTRALIA.]

FEDERAL COMMISSIONER OF TAXATION . APPELLANT;

AND

ROBINSON AND MITCHELL PROPRIETARY LIMITED . . . . . } RESPONDENT.

H. C. OF A. 1941.

SYDNEY, *Aug.* 18, 19, 20; *Oct.* 3.

McTiernan J.

Income Tax (Cth.)—Assessable income—Deduction—Retiring allowance paid by company to former managing director—"Losses and outgoings incurred in gaining or producing the assessable income"—"Losses and outgoings necessarily incurred in carrying on a business for the purpose of gaining or producing such income"—Income Tax Assessment Act 1936-1937 (*No.* 27 *of* 1936—*No.* 5 *of* 1937), *sec.* 51 (1).

A company paid an annual sum by way of retiring allowance to a former managing director, who still retained his shares in the company. The evidence leading to the inference that he required the retiring allowance to be paid in order that he should get a return from his shares in the company as soon as he ceased to draw his salary as managing director,

Held that the allowance was not a loss or outgoing "incurred in gaining or producing" the company's assessable income, or necessarily incurred in carrying on the company's business for the purpose of gaining or producing such income, within the meaning of sec. 51 (1) of the *Income Tax Assessment Act* 1936-1937.

APPEAL from the board of review.

The Federal Commissioner of Taxation appealed to the High Court against a decision of the board of review upholding a claim by the taxpayer company that an allowance paid to a former managing director was deductible from the income derived by the company during the year ended 30th June 1937.

Sec. 51 (1) of the *Income Tax Assessment Act* 1936 provides: "All losses and outgoings to the extent to which they are incurred in gaining or producing the assessable income, or are necessarily

incurred in carrying on a business for the purpose of gaining or producing such income, shall be allowable deductions except to the extent to which they are losses or outgoings of capital, or of a capital, private or domestic nature, or are incurred in relation to the gaining or production of exempt income."

The appeal was heard by *McTiernan* J., in whose judgment the material facts are fully stated.

Mitchell K.C. (with him *Collier*), for the appellant.

Weston K.C. (with him *McIntosh*), for the respondent.

Cur. adv. vult.

Oct. 3.

McTIERNAN J. delivered the following written judgment:—

The case relates to an assessment to Federal income tax in respect of income derived by the respondent company during the year ended 30th June 1937, and is to be decided under the *Income Tax Assessment Act* 1936.

The appeal is brought by the commissioner under sec. 196 (1) against a decision of the board of review upon a reference under sec. 187. The board decided that a sum of £660, which the company paid out in the relevant year, was an allowable deduction under both limbs of sec. 51 (1), and consequently it upheld an objection by the company to its assessment on the ground that it was excessive. The decision was that of a majority of three members of the board, whose view prevailed by force of sec. 194 (*b*). These proceedings, which sec. 196 (1) describes as an appeal, are in the original jurisdiction of the court. No oral evidence was given in the present appeal. The materials upon which it is to be decided are the exhibits received by the board and a transcript of the evidence and argument which it heard. The parties to the appeal agreed upon this course. The transcript also contains a copy of the board's decision and of the findings of fact and reasons in law, as they are described in sec. 195 (2), of the members of the board.

The company's income for the relevant year consisted of commissions for work done by it as an insurance broker and underwriting agent. The recipient of the sum of £660, which the board decided was an allowable deduction, had been the managing director of the company since its incorporation in 1925 down to the end of 1933, when he retired to enter a new field of business. The sum is entered in the company's profit and loss account for the year ended 30th June 1937 under the description of a retiring allowance. This description does not suggest a payment the tendency of which is to

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produce income, but rather a payment made out of income after it has been earned. It suggests that the recipient has withdrawn from any participation in the operations by which income is earned. But yet such a payment might in special circumstances be part of the expenditure incurred in producing a taxpayer's income. The question whether any retiring allowance is a payment of that nature is one of fact: See *Maryborough Newspaper Co. Ltd.* v. *Federal Commissioner of Taxation* (1), and cases cited by *Rich* J. (2). It appears from the transcript before the court that the only question which the parties contested before the board and upon which it gave a decision was whether the payment of £660 was an outgoing within sec. 51 (1). Neither of the members who constituted the majority, nor the chairman, who dissented from their decision, gave a decision on the question whether the payment was excluded from sec. 51 (1) on the ground that it was of a capital nature. Sec. 196 (1) gives a right of appeal from a decision of the board only if it involves a question of law. It is a condition preliminary, therefore, to the commissioner's right to have the question whether the payment was an allowable deduction determined in these proceedings, that the majority of the board have gone wrong on a question of law and that the question is involved in their decision. It is necessary first to decide whether this condition does exist. In the formal statement of its decision the board declared that " after consideration of the evidence and arguments submitted by the representatives of the taxpayer and the commissioner respectively, it decided to uphold the taxpayer's objection to the assessment." The decision was upon the question of fact whether the retiring allowance was a loss or outgoing within either limb of sec. 51 (1). But the decision involved at least these two questions of law—whether there was any evidence upon which the board could find that the payment was within either limb of the sub-section. If there was no such evidence the decision of the board involves a question of law which it has decided wrongly, and, in consequence, the question whether the company's objection to the assessment should be upheld or not passes within the jurisdiction of the court in these proceedings.

The first limb of sec. 51 (1) extends to any loss or outgoing reasonably and properly incurred in gaining or producing the assessable income, whereas the deduction allowed under the second limb is rigidly confined to any loss or outgoing necessarily incurred in carrying on business for the purpose of gaining or producing the assessable income. It was conceded on behalf of the taxpayer that the circumstances were not capable of satisfying the requirements of the second

(1) (1929) 43 C.L.R. 450. (2) (1929) 43 C.L.R., at p. 452.

limb of the sub-section. The company stands on the first limb. The question then is whether the board fell into an error of law in determining that the evidence was sufficient to justify the conclusion that the payment claimed as a deduction satisfied the provisions of that part of the sub-section.

The material facts before the board were that the company acted as an insurance broker mainly for persons and corporations who had been introduced by William Mitchell, the recipient of the retiring allowance. They continued to transact business through the agency of the company because of his association with its management. The company depended on their adherence to it to earn the commissions, which were its only form of income. These business connections had been collected by W. Mitchell while he was the principal member of a firm consisting of himself and his brother J. Mitchell. The company was incorporated to take over their business, and they became directors. W. Mitchell became the managing director, and he served in that capacity from the formation of the company in 1925 down to the end of 1933, when he retired. In 1926, D. H. V. Mair was appointed a director, and he and J. Mitchell were still directors after 30th June 1937. It was shown that the capital of the company was 18,007 fully paid shares of £1 each. W. Mitchell held 12,001 until 1932, when he gave 1,000 shares to Mair and 1,000 shares to an employee of the company. W. Mitchell held the balance of the 12,001 shares throughout the year which ended on 30th June 1937. J. Mitchell was at all times the holder of 6,001 shares. The company had no tangible assets. Its capital was represented by goodwill. The company did not pay dividends on its shares, but its receipts were exhausted by the salaries paid to its directors and other expenditure. The salaries were substantial. But W. Mitchell's salary had declined from £3,209, which he received in 1926, to £1,150, which he received for the year which ended on 30th June 1933. In those years the salaries received by J. Mitchell and Mair were £1,000 and £750 respectively.

W. Mitchell retired from the positions of managing director and director because he was not hopeful about the prospects of the business of an insurance broker, and he began business as an attorney of an insurance company, in which he established his son. He had but little, if any, discussion with the other directors about his intention to take this step. At a meeting of directors on 18th November 1932 W. Mitchell proposed that he should be paid a retiring allowance of £800 per annum for the ensuing four years and that the rate should be revised at the end of that time in the light of the company's financial position. The proposal was passed unanimously. W.

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Mitchell's voting power, despite his larger holding of shares, was only equal to that of his brother, J. Mitchell. He and Mair made no other objection than that the amount of the allowance was excessive. Their objection was prompted by the fall in the company's receipts and the possibility that the decline would continue.

It has been observed that after his retirement W. Mitchell remained the holder of 10,001 shares in the company. In each of the years ended 30th June 1934, 1935 and 1936, he received the full amount of the retiring allowance. In each of those years J. Mitchell and Mair received a salary in excess of that which either received for the year 1933. At the end of the period for which the retiring allowance was granted, J. Mitchell told W. Mitchell that the company could not carry on and continue to pay him £800 per annum. They discussed the business and its possibilities and agreed that the retiring allowance be reduced to £520. The directors, J. Mitchell and Mair, then passed a resolution at a directors' meeting that W. Mitchell be paid a retiring allowance at the rate of £520 for three years from 1st January 1937, subject to the variation of the rate by mutual consent. The payment ceased at the end of 1939. In that year W. Mitchell sold his shares in the company to J. Mitchell at 4s. per share. The evidence shows that after W. Mitchell's retiring allowance was reduced the salary of each director was again increased.

The sum of £660, described in the profit and loss account as a retiring allowance, consists of the sum of £400, paid for the six months ended 31st December 1936 at the rate of £800 per annum, and of the sum of £260, the amount of retiring allowance paid for the six months ended 30th June 1937 at the rate of £520 per annum.

At the time he retired W. Mitchell was able to perform the duties of managing director efficiently, and his retirement was very detrimental to the company, especially for the reason that his participation in the management was the factor which more than any other was calculated to ensure the continued patronage of the people for whom it had been acting as an insurance broker.

The evidence shows that neither J. Mitchell, nor Mair, opposed the retirement of W. Mitchell, and that no obligation was imposed upon him not to compete with the company. Each of them said in evidence that he agreed that W. Mitchell was entitled to a retiring allowance in recognition of his services to the company. Each of them demurred only to the amount which W. Mitchell proposed that he should be granted.

The facts of the case are supplemented by the evidence which J. Mitchell and Mair gave of the motive with which they were actuated in bowing to W. Mitchell's proposal that the amount of the retiring

allowance should be £800. The motive was determined by their appreciation of W. Mitchell's influence with the company's customers. They realized that if he exercised that influence against the company, or refrained from exercising it in its favour at a critical time, the result would be disastrous to the business. They were anxious not to alienate W. Mitchell and to avoid any possibility of arousing in him any antagonism. This evidence of the motive which the directors had in accepting W. Mitchell's entire proposal is relied upon by the company to show that the retiring allowance was an outlay incurred to ensure that the company's income would be kept up to its normal level, notwithstanding his retirement. This view, if at all tenable, could be taken only of so much of the allowance as exceeds the amount to which the two directors would have agreed without objection. If the retiring allowance had been fixed at that amount the case would clearly not be susceptible of the inference that it was expended in order to ensure the customary flow of income. In any case, the amount by which the retiring allowance of £800 exceeds that to which the directors would have agreed without objection is not proved. Besides, there is no evidence that they regarded the amount of £520 as excessive, and it is to be remembered that half of the amount claimed as a deduction was paid at the reduced yearly rate of £520. The only purpose indicated by these facts for which the sum of £660 was paid, was to provide an allowance for its managing director upon his withdrawal from its management, in recognition of his services to the company. The motive which the directors had in agreeing to the payment of the allowance cannot affect the purpose or the tendency of the payment. The evidence of their motive merely shows why they voted, perhaps reluctantly, for the payment of a retiring allowance of a larger amount than they thought was warranted by the financial position of the company.

The evidence fails to support the suggestion made before the board that the payment of the allowance was incidental to a scheme for reorganizing and retrenching the management to eliminate friction in that department of the company and to save the balance between W. Mitchell's salary and the amount of the retiring allowance.

In my opinion there was no evidence upon which the board could properly find that the sum of £660 paid to W. Mitchell in the relevant year was an outlay within sec. 51 (1). It follows that the majority erred on a question of law which is involved in the decision from which the commissioner appeals, and the court has jurisdiction to determine the question whether the sum is an allowable deduction under sec. 51 (1). Upon the material before the court the conclusion

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cannot be reached that the sum was a loss or outlay incurred in gaining the company's assessable income, or was necessarily incurred in carrying on the company's business. The inference to which the evidence leads is that W. Mitchell required the retiring allowance to be paid in order that he should get a return from his shares in the company as soon as he ceased to draw his salary as managing director. In my opinion the payment lay outside the range of any expenditure which the company bore to gain its assessable income and the evidence fails to show that the expenditure was necessarily—*ex necessitate* the business—incurred. The onus was by sec. 190 (*b*) cast upon the company to make out its objection that the assessment was excessive. It has failed to sustain that onus.

The appeal is allowed and the assessment is confirmed. The respondent is to pay three-quarters of the costs of the commissioner of the appeal.

Appeal allowed. Assessment confirmed.

Solicitor for the appellant, *H. F. E. Whitlam*, Commonwealth Crown Solicitor.

Solicitor for the respondent, *A. O. Ellison.*

J. B.