

[HIGH COURT OF AUSTRALIA.]

EMU BAY RAILWAY COMPANY LIMITED . APPELLANT;

AND

FEDERAL COMMISSIONER OF TAXATION . RESPONDENT.

H. C. OF A. *Income Tax (Cth)—Assessment—Deductions—“Outgoings . . . incurred in  
1944. gaining or producing the assessable income”—Company—Stock—Interest payable  
out of net annual income—Income insufficient to pay interest—Income Tax  
Assessment Act 1936-1940 (No. 27 of 1936—No. 65 of 1940), s. 51.*

MELBOURNE,

Oct. 3;

Nov. 6.

Latham C.J.,  
Rich, Starke,  
McTiernan and  
Williams JJ.

A company and trustees for its creditors entered into a debenture trust deed whereby the company undertook to issue debenture stock to the creditors and stock certificates in a form prescribed by the deed were issued accordingly. By the deed, the company acknowledged itself indebted to the stock holders in a specified sum which, until redemption, was to bear interest payable half-yearly; the interest was “to be a charge upon and payable only out of the net annual income of the company.” The company covenanted to pay the amount of the stock and interest thereon in accordance with the terms of the deed and charged its assets in favour of the trustees to secure the payment of the stock and interest. The deed created a trust for sale and empowered the trustees in certain events to enter into possession of and realize the assets. It also contained a provision that, during a period which had expired before the income year 1939, the interest on the stock “shall be payable only out of the net income of the company . . . and after the expiration of such period the interest . . . shall be cumulative.” The company did not in the year 1939 or thereafter pay or credit to the stock holders any sum for interest in respect of that year. It had no net income in that year; in fact, as appeared from its profit and loss account, it incurred a loss. Nevertheless, unless it was entitled to a deduction in respect of the interest, it had a taxable income for the purposes of the *Income Tax Assessment Act 1936-1940*. It was assessed to tax on that income by the Commissioner, who refused to allow any deduction in respect of the interest.

*Held*, by Latham C.J., Starke and McTiernan JJ. (Rich and Williams JJ. dissenting), that the amount of interest was not deductible as an outgoing “incurred in gaining or producing the assessable income,” within the meaning of s. 51 of the *Income Tax Assessment Act*.



## CASE STATED.

On an appeal to the High Court against an assessment to income tax, *Starke J.* stated for the Full Court a case which was substantially as follows :—

1. The Emu Bay Railway Co. Ltd. (hereinafter called “the appellant”) is a company duly incorporated in the State of Tasmania. Capital moneys have been raised by way of share capital and by means of debentures of which a considerable sum has been expended in the construction of railway lines in Tasmania. At all times material the appellant carried on its business operating these lines.

2. For the purposes of assessment of income tax in respect of the financial year 1940-1941, with the leave of the Commissioner of Taxation (hereinafter referred to as “the respondent”), the appellant adopted an accounting period of twelve months ending on 31st December 1939.

3. On 11th July 1899, the appellant executed an indenture with Charles Augustin Hanson and Robert Bruce Ronald (therein referred to as “the present trustees”) to secure the repayment by the appellant of certain principal moneys and interest owing to holders of debentures then or thereafter to be issued by the appellant to the amount of £200,000. The provisions of that indenture are not relevant to the determination of this case. It contains certain detailed provisions relating to the exercise by the trustees of their powers and other matters of a purely administrative or machinery kind.

4. By an indenture of lease dated 28th December 1903, The Emu Bay and Mount Bischoff Railway Co. Ltd., a company incorporated in the State of Tasmania, granted to the appellant a lease over certain railway lines and other premises at an annual rental of £10,000 upon terms and conditions not material to this case.

5. The appellant fell into arrears in respect of interest due to the holders of debentures issued pursuant to the indenture referred to in par. 3 hereof and from time to time issued to such holders funding interest coupons in respect of such indebtedness in respect of interest.

6. The appellant fell into arrears in respect of rent due to The Emu Bay and Mount Bischoff Railway Co. Ltd. and from time to time issued to such company funded rent debentures in respect of such indebtedness in respect of rent.

7. Some time prior to the year 1924, The Emu Bay and Mount Bischoff Railway Co. Ltd. issued debenture stock amounting to £130,900 and bearing interest at the rate of four and a half per cent per annum.

8. In the year 1924, the appellant was indebted as follows :—  
(a) in the sum of £172,000 in respect of the capital owing in respect

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of debentures issued by it pursuant to the indenture referred to in par. 3 hereof; (b) in the sum of £46,440 in respect of interest owing to holders of such debentures and in respect of which funding interest coupons had been issued as aforesaid; (c) in the sum of £9,524 in respect of interest owing to the holders of the funding interest coupons; (d) in the sum of £34,000 in respect of rent owing to The Emu Bay and Mount Bischoff Railway Co. Ltd. and in respect of which funded rent debentures had been issued to that company as aforesaid; (e) in the sum of £7,100 in respect of interest owing to the holders of the funded rent debentures.

9. In the year 1925, the trustees of the indenture referred to in par. 3 hereof were Frederick John Gordon and John Henry Clifford Johnston.

10. On 7th April 1925, the appellant and the trustees entered into a debenture trust deed which is hereinafter called Exhibit "B." [The provisions of this deed appear sufficiently in the judgments hereunder.]

11. Before the execution of Exhibit "B" the provisions thereof had been duly submitted to and approved of by the holders of debentures issued by the appellant pursuant to the indenture referred to in par. 3 hereof and of debentures issued by The Emu Bay and Mount Bischoff Railway Co. Ltd.

12. Pursuant to the provisions of Exhibit "B," the appellant created debenture stock to the value of £130,900 bearing interest at four and a half per cent per annum and issued the debentures to the holders of debentures issued by The Emu Bay and Mount Bischoff Railway Co. Ltd. in exchange for the debentures so issued to them by the last-named company.

13. Pursuant to the provisions of Exhibit "B," the appellant created debenture stock to the value of £267,064 bearing interest at five per cent per annum and issued the same as follows:—(a) debenture stock to the value of £172,000 to the holders of debentures issued by it as set out in par. 3 hereof in exchange for debentures then held by them of an equal value; (b) debenture stock to the value of £55,964 to the holders of funding interest coupons hereinbefore referred to; (c) debenture stock to the value of £39,100 to The Emu Bay and Mount Bischoff Railway Co. Ltd. in part payment for assets transferred by that company to the appellant.

14. The debenture stocks referred to in pars. 12 and 13 hereof were issued upon the terms and conditions set out in Exhibit "B" and the Second and Third Schedules thereto.

15. For the twelve months ending on 31st December 1939, the appellant incurred a loss of £63 according to its profit and loss



account. For the same period, its taxable income, if the deduction hereinafter referred to is not allowable, was £6,675.

16. Interest calculated at the rate of five pounds per cent per annum upon the capital of the debenture stock described in Exhibit "B" as "the five per centum Stock" amounted for the twelve months ending on 31st December 1939 to £13,333 13s. 6d., but no part of that sum was during that period or has since been paid or credited to any holders of such stock.

17. For the purpose of the assessment of the appellant to income tax for the financial year 1940-1941, the respondent assessed the appellant upon a taxable income of £6,675 and issued notice of assessment claiming that the sum of £751 5s. was payable in respect of that income tax.

18. The appellant duly gave notice of objection to the assessment upon the ground that the interest on the debenture stock was cumulative and accrued due in respect of the year of income. The respondent disallowed the objection, and at the request of the appellant it was treated as an appeal to the High Court.

19. The appellant claims that for the purposes of its assessment to income tax the respondent is bound to treat the sum of £13,333 13s. 6d., being interest for one year upon the five per cent stock, as an allowable deduction under s. 51 of the *Income Tax Assessment Act* 1936-1940, being outgoings incurred in gaining or producing the assessable income or necessarily incurred in carrying on a business for the purpose of gaining or producing such income.

The following question of law was stated for the opinion and consideration of the Full Court:—

Whether upon the facts stated, the said sum of £13,333 13s. 6d. should be allowed as a deduction from the assessable income of the appellant upon the grounds:—

- (a) that the said sum is an outgoing incurred in gaining or producing the assessable income of the appellant; or
- (b) that the said sum is an outgoing necessarily incurred by the appellant in carrying on a business for the purpose of gaining or producing such income?

*Menzies* K.C. (with him *Fullagar* K.C. and *Dean* K.C.), for the appellant. This is not the ordinary case of a debenture, but is a case where debenture stock is issued on the terms of a trust deed. The deed must therefore be read as the basis of the contract with the stock holder. If there is a clear term in the body of the deed and something inconsistent with it in a schedule to the deed, the term

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in the body of the deed should prevail. The five per cent stock certificate the form of which appears in the third schedule to the deed must be read, in so far as is necessary, so as to reconcile its terms with those in the body of the deed. In this case, it is only in the third schedule to the deed that there is to be found the statement (without any express limit as to time) that "the interest is to be a charge upon and payable only out of the net annual income." This, regarded as unlimited as to time, is inconsistent with, and must yield to, the provision in the body of the deed (clause 7) that "during the period of ten years ending on the 31st of December 1933 the interest on the 5 per cent stock shall be payable only out of the net income of the company from time to time available . . . and after the expiration of such period the interest on the 5 per cent stock shall be cumulative." The effect of this clause is to confine to the period which it specifies the limitation of the liability of the appellant to pay the interest *out of net income only*, so that no such limitation exists in respect of interest after that period; and the words of the schedule should be construed accordingly. In any event, the stock together with interest is charged on the appellant's capital assets; therefore there is a liability to pay the interest at some time, and the incurring of that liability is properly attributed to the year in respect of which the interest is payable. Accordingly, the amount in question is an "outgoing incurred" in 1939, within the meaning of s. 51 of the *Income Tax Assessment Act*. A liability cannot be "incurred" by being discharged, and "outgoing incurred" cannot be confined to debts which have been paid in the relevant year; it must cover liabilities which have arisen, whether paid or not, in the relevant year.

[He referred to *W. Nevill & Co. Ltd. v. Federal Commissioner of Taxation* (1), per *Latham C.J.*(2); per *Dixon J.* (3); *Amalgamated Zinc (De Bavay's) Ltd. v. Federal Commissioner of Taxation* (4), per *Dixon J.*; *Ratcliffe and McGrath's Law of Income Tax* (1938), pp. 388, 389, 512; *Elder Smith & Co. Ltd. v. Commissioner of Taxation (N.S.W.)* (5), per *Dixon J.*; *Palmer's Company Precedents* 14th ed. (1933), vol. III, p. 8.]

*Eager K.C.* (with him *P. D. Phillips*), for the respondent. There is no inconsistency between the terms of the third schedule and clause 7 of the deed, and nothing in clause 7 by relation to which the schedule can or must be read down. The only obligation under the

(1) (1937) 56 C.L.R. 290.

(2) (1937) 56 C.L.R., at p. 302.

(3) (1937) 56 C.L.R., at p. 307.

(4) (1935) 54 C.L.R. 295, at p. 309.

(5) (1932) 47 C.L.R. 471, at p. 477.



deed was to pay the interest out of net annual income. As there was no net income for 1939, there was no liability at all for interest for that year, or, at all events, no liability arising—nothing “incurred”—in that year. Further, as there was no payment in 1939, there was no “outgoing” in that year; this is not a question whether there is an existing debt payable *in futuro*; it is merely a question of payment within the relevant year. [He referred to *Jolly v. Federal Commissioner of Taxation* (1); *W. Nevill & Co. Ltd.’s Case* (2), per Latham C.J. (3); per Rich J. (4); per Dixon J. (5); per McTiernan J. (6); *New Zealand Flax Investments Ltd. v. Federal Commissioner of Taxation* (7); *West Ham Corporation v. Grant* (8); *Naval Colliery Co. (1897) Ltd. v. Inland Revenue Commissioners* (9); *Amalgamated Zinc (De Bavay’s) Ltd.’s Case* (10), per Dixon J.] The onus is on the appellant to show that it is entitled to the deduction claimed. Even if the amount in question had been paid, the payment would only be a distribution of profits and not the payment of a debt; the agreement to pay out of net income was merely an agreement to distribute income when earned, and there would be no outgoing incurred in the production of that income (*Commissioner of Taxation (W.A.) v. Boulder Perseverance Ltd.* (11)). [He also referred to *Indian Radio & Cable Communications Co. Ltd. v. Income Tax Commissioner, Bombay Presidency and Aden* (12), approved in *British Sugar Manufacturers Ltd. v. Harris* (13); *A. W. Walker & Co. v. Inland Revenue Commissioners* (14); *Last v. London Assurance Corporation* (15).]

*Menzies K.C.*, in reply.

*Cur. adv. vult.*

The following written judgments were delivered:—

LATHAM C.J. Case stated in an appeal by the Emu Bay Railway Company against an assessment to income tax in respect of the financial year 1940-1941. The question asked relates to a sum of £13,333 13s. 6d. which it is claimed should be allowed as a deduction from the assessable income of the company. The company contends that the said sum was an outgoing incurred in gaining or producing the assessable income of the appellant and was accordingly a proper

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(1) (1934) 50 C.L.R. 131, at p. 137.

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

(3) (1937) 56 C.L.R., at p. 302.

(4) (1937) 56 C.L.R., at p. 304.

(5) (1937) 56 C.L.R., at p. 307.

(6) (1937) 56 C.L.R., at p. 309.

(7) (1938) 61 C.L.R. 179.

(8) (1888) 58 L.J. Ch. 121.

(9) (1928) 138 L.T. 593.

(10) (1935) 54 C.L.R., at p. 307.

(11) (1937) 58 C.L.R. 223, at p. 233.

(12) (1937) 3 All E.R. 709.

(13) (1938) 2 K.B. 220.

(14) (1920) 3 K.B. 648, at p. 652.

(15) (1885) 10 App. Cas. 438, at p. 444.



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deduction under the Commonwealth *Income Tax Assessment Act* 1936-1940, s. 51. That section provides that (a) all losses and outgoings to the extent to which they are incurred in gaining or producing the assessable income, or (b) are necessarily incurred in carrying on a business for the purpose of gaining or producing such income, shall be allowable deductions, subject to exceptions which are not material for the purpose of this case. The appellant has, in argument, relied only upon the part of the section which I have referred to as (a).

On 7th April 1925, the company entered into a debenture trust deed with certain trustees under which it was provided that two sets of debenture stocks should be issued bearing interest respectively at  $4\frac{1}{2}$  per cent and 5 per cent. The  $4\frac{1}{2}$  per cent stock had priority over the 5 per cent stock. Interest on the  $4\frac{1}{2}$  per cent stock was paid in the income year in question, but the sum of £13,333, representing 5 per cent interest upon the amount of 5 per cent stock issued, was not paid. The company contends that, though it was not paid, the interest had become payable so that the liability to pay it had accrued, and that therefore it was an "outgoing incurred" within the meaning of s. 51 of the Act. The Commissioner makes three replies to this contention. In the first place, it is argued that no interest had become payable under the terms of the trust deed because, it is said, the obligation to pay interest upon the 5 per cent stock was an obligation to pay interest only out of what is referred to in the deed and a schedule thereto as net income or net annual income of the company, and it is common ground that there has in fact been no net income of the company in any year since the trust deed was executed. Secondly, the Commissioner contends that, even if this contention be wrong and the interest did become payable, it was not in fact paid, and therefore cannot be regarded as an outgoing incurred within the meaning of s. 51. Thirdly, the Commissioner contends that, as the interest was payable only out of the net income of the company, the provision for its payment constituted an agreement to distribute the income of the company when earned, so that it could not be regarded as an outgoing incurred in the production of that income. If the first argument of the Commissioner is right, it will not be necessary to consider the second and third arguments to which I have referred.

The trust deed recites that it was agreed that the 5 per cent stock should bear interest and be secured in manner and have the rights described in the third schedule. Clause 1 (B) of the deed contains an acknowledgment by the company that it is indebted to the trustees on behalf of the holders of the 5 per cent stock in a specified sum carrying interest at the rate of 5 per cent per annum payable half-yearly.



Clause 3 provides that the two stocks are each to rank as a charge on the company's undertaking with the priorities and in manner set out in the second and third schedules to the deed.

Clause 5 provides that until redemption the company shall pay to the stock holders whose stock remains outstanding interest on such respective stocks at the respective rates of  $4\frac{1}{2}$  per cent and 5 per cent per annum "as mentioned and provided in the Second and Third Schedules hereto."

Clause 6 provides that "the said respective stocks shall be held subject to the conditions relative thereto hereinafter or in the said Second and Third Schedules hereto expressed."

Clause 7 is in the following terms:—"During the period of ten years ending on the 31st of December 1933 the interest on the 5 per cent Stock shall be payable only out of the net income of the Company from time to time available after payment of the interest upon the  $4\frac{1}{2}$  per cent Stock and after making proper provision for the upkeep of the Company's railways rolling stock workshops buildings plant and tools including the setting aside of reasonable sums for depreciation and after paying the Company's directors fees and the remuneration of the Trustees and discharging all other outgoings and making all other provisions properly chargeable against revenue and necessary to secure the efficient maintenance and working of the said railways and after the expiration of such period the interest on the 5 per cent Stock shall be cumulative." This clause draws a distinction between the period of ten years ending on 31st December 1933 and the subsequent period. During the said ten years, interest on the 5 per cent stock is payable only out of the net income of the company as specified in the clause. After the expiration of that period, the interest becomes cumulative. The meaning of these provisions, in my opinion, is that arrears of interest do not accumulate during the first ten years, so that arrears in respect of one year do not become payable out of income of any subsequent year. During the ten years, the interest is non-cumulative. After the expiry of the ten years, however, the interest is cumulative; that is to say, arrears of interest relating to that period do not disappear, but continue to be payable by the company. It was suggested in argument that the clause might be construed to mean that the total interest for the first ten years became payable out of the total net income for those years, but not out of any subsequent income. This view does not appear to me to be justified by the words of the clause, which I regard as drawing a distinction between an initial period during which interest is non-cumulative and a subsequent period during which it is cumulative. But it is unnecessary actually to decide this point for the purposes of

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this case. It is at least clear that arrears of interest for the year 1939-1940 (the income year in question) were not non-cumulative.

It may be observed that the reference to the net income of the company in clause 7 is impliedly a reference to the net annual income of the company because the net income can only be ascertained by taking an account relating to a period, and the natural meaning of the provision is that the net income should be ascertained annually by deducting from the income the various annual charges mentioned—the  $4\frac{1}{2}$  per cent interest and the other outgoings mentioned in the clause.

Clause 10 provides that the company as beneficial owner charges in favour of the trustees for securing the payment of the  $4\frac{1}{2}$  per cent and the 5 per cent stock respectively “and the interest thereon as aforesaid” all the business and undertaking of the company, its book debts &c. The clause also contains a provision that the company shall not create or suffer to be created any other mortgage charge or lien upon the assets in priority to the charge created by the deed.

Clause 11 provides that the company covenants with the trustees to pay to them “(B) the amount of the 5 per cent Stock and Interest thereon in accordance with the terms set out in the Third Schedule.”

Thus clauses 3, 5, 6 and 11 all define the obligations of the company in relation to the 5 per cent stock by reference to the third schedule.

Clause 13 provides that the company will perform the covenants with respect to the stock which are expressed in the deed or incorporated by reference to an earlier indenture.

Clause 14 deals with priorities and provides that the  $4\frac{1}{2}$  per cent stock and the interest thereon shall be a first charge on certain premises and that subject thereto both stocks “and the interest thereon respectively” shall rank *pari passu* as a first charge on all the other property charged by the trust deed.

Clause 17 deals with the disposition of the proceeds of realization if the trustees exercise the trust for sale referred to in the deed. After payment of certain expenses and subject to the provision as to priority of  $4\frac{1}{2}$  per cent stock, the proceeds of realization are to be applied “in or towards the payment to the holders of the  $4\frac{1}{2}$  per cent Stock and 5 per cent Stock equally in proportion to the respective amounts thereof due to them respectively and all arrears of interest thereon.”

Clause 21 provides that, upon the trustees being satisfied that “the whole of the  $4\frac{1}{2}$  per cent Stock and the 5 per cent Stock and all interest thereon respectively” has been paid, or satisfied and upon payment of costs &c., the trustees shall reconvey the mortgaged premises to the company.



It will be observed that these provisions relating to the application of the proceeds of realization of the assets charged by the deed cover in terms "all arrears of interest" and "all interest" on the  $4\frac{1}{2}$  per cent and the 5 per cent stock. It may be that the consequence is that, though no arrears of interest are payable otherwise than out of the net income as available from year to year during the first ten years, yet if the power of sale is exercised these arrears constitute a charge upon the proceeds. But the matters requiring decision in the present case do not necessitate a determination of this question.

It is now necessary to consider the terms of the third schedule by reference to which the deed, in clauses 3, 5, 6 and 11, specifies the obligations of the company and the rights of the stock holders.

The third schedule consists of two parts, the first containing certain "terms and conditions on which the 5 per cent Stock is to be issued." These terms and conditions are made part of the contract between the company and the trustees by clause 11 of the deed, which contains an express reference to the "terms" set out in the third schedule. These terms provide for half-yearly payment of interest, and contain the following provision: "The interest is to be a charge upon and payable only out of the net annual income of the Company as defined in the Trust Deed subject to the prior charge thereon of the interest upon the  $4\frac{1}{2}$  per cent Stock. The interest is not to be cumulative until after the 31st day of December 1933." This, in my opinion, is an unambiguous provision that the interest at all times is to be a charge upon and payable only out of the net annual income of the company, becoming cumulative after 31st December 1933. The net annual income of the company is actually defined by the trust deed in the provisions of clause 7, to which reference has been made, though that clause does not use the word "definition." The reference in the third schedule to "net annual income" can refer only to the provisions of that clause. The result is that, as there has never been any annual net income of the company since 31st December 1933 (or at all), the sum of £13,333 13s. 6d. has not become payable.

The second part of the third schedule contains a form of stock certificate. This stock certificate (to be issued to the holder of stock) contains the following provision: "The interest is non-cumulative until after the 31st of December 1933 and is payable only out of the net income of the Company of each year as provided in the Trust Deed." (This provision, I think, resolves any doubt which might have arisen as to whether arrears accumulated in any sense during the period of ten years. The provision that the interest is non-cumulative until after 31st December 1933 shows plainly that

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it was intended that interest should be payable during that period only if the net income of the relevant year provided for it. But, as I have said, this is a point which it is not necessary to decide for the purposes of this case.) What is important is the definite provision, applying to all the 5 per cent interest, that the interest is payable "only out of the net income of the Company."

As there has never been any such net income, the interest which the company claims is allowable as a deduction did not become payable, has not become a debt, and may never become a debt. As the cumulative period has now been reached, it might become a debt (if the company should have net income hereafter), and in that case it could certainly, if it were paid, and possibly even if it were not paid, be a proper deduction from the income of the company for income tax purposes. The words "outgoings incurred" should not be limited to expenditure actually made. They include a liability presently incurred and due though not yet discharged—*Jolly v. Federal Commissioner of Taxation* (1); *W. Nevill & Co. Ltd. v. Federal Commissioner of Taxation* (2)—cases on a provision not quite identical with s. 51 of the present Act, but which does not differ in any particular which is material for present purposes. It may be argued that the words include a liability which falls within the description *debitum in praesenti, solvendum in futuro*. But the alleged liability in the present case does not even answer this description. As things stand at present, the interest has not become payable, and all that can be said is that there exists at the present time the possibility of a liability accruing in the future, such possibility depending, not only upon the derivation of net income, but also upon the amount of such income derived. In my opinion, such a possibility cannot be regarded as an outgoing incurred within the meaning of s. 51 of the *Income Tax Assessment Act*. Not only has no outgoing been made, but no liability to make an outgoing has come into existence.

As against this conclusion, the appellant relies upon clause 7. The argument is that clause 7 is an express provision that during a period of ten years (which is now past) interest shall be payable only out of the net income of the company. It is argued that this provision is plainly intended to confine to the period of the first ten years the limitation of the liability of the company to pay out of net income only, and that it should be held that no such limitation exists during any subsequent period. If this is the true view, then the amount claimed as a deduction has become payable by the company, though it has not been paid.

(1) (1934) 50 C.L.R. 131, at p. 137.

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



In my opinion, it is not proper to attribute such an operation to clause 7 in face of the many provisions in the deed which expressly refer to the third schedule for the purpose of determining the obligations of the company and the rights of the stock holder. The provisions in the third schedule are not ambiguous in relation to this matter and the provisions in the deed which refer to the third schedule are not ambiguous. Clause 7 does not contain any provision which is inconsistent with the third schedule. It contains a provision with respect to the first ten years which is consistent with the provisions of the third schedule, though it duplicates those provisions in part—in respect of that period of ten years.

I am, therefore, of opinion that, as the sum of £13,333 13s. 6d. is payable only out of the net income of the company as defined in the deed, and as there is not and never has been any such income, the sum claimed as a deduction has not become payable; it is not a debt or a liability of any kind, and it cannot be regarded as an outgoing within the meaning of the relevant section of the *Income Tax Assessment Act*. Accordingly it is unnecessary for me to consider the further arguments submitted on behalf of the Commissioner.

For the reasons which I have given, the question in the case should be answered in the negative.

RICH J. In calculating the taxpayer's assessable income for the financial year 1940-1941, the parties agreed that the twelve months ending 31st December 1939 should be deemed to be the year of income for the purpose of determining whether the sum in question of £13,333 13s. 6d. is to be allowed as an outgoing to the extent to which it was incurred in carrying on the taxpayer's business for the purpose of gaining or producing such income (*Income Tax Assessment Act* 1936-1940, s. 51). The debenture trust deed contains the relative rights and obligations of the parties to it and is framed in the form in *Palmer's Company Precedents*, with such variations as the particular case requires. The deed secures debenture stock called "irredeemable," as no date is fixed for repayment of the principal, but there are a trust for sale, and a power for the trustees under the deed to enter and take possession, and a trust to apply the proceeds of realization (*inter alia*) towards the payment of the principal moneys, interest "and all arrears of interest" (clause 17). For the period of the first ten years interest is made payable only out of net profits and is non-cumulative. Accordingly, if the profit of any one year during that period was insufficient to pay the interest, there would have been no claim on subsequent profits for the deficiency: Cf. *Palmer's Company Precedents*, Part III, 15th ed. (1938), p. 301. The

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meaning of net profits is to be found in the dictionary contained in clause 7. The subject, however, of this appeal is concerned with the period following the first ten years and the sum in question is the unpaid interest for the relevant period on the 5 per cent stock. During this period, the interest is cumulative and although it is payable only out of net profits as defined (third schedule) it is an existing debt or obligation and is ultimately payable out of the proceeds of sale (clause 17). The trust deed begins with the acknowledgment in clause 1 (B) that the company is indebted to the trustees on behalf of the holders of the 5 per cent stock in the sum of £267,064 carrying interest at the rate of 5 per cent per annum payable half-yearly on 1st April and 1st October in each year. And the payment to the holders of such stock of interest for each half year or other period on such stock held by them respectively shall operate in satisfaction of the interest for such half year or other period payable to the parties under this clause. The deed provides in the usual way for a floating charge which attaches upon the happening of certain events. A borrowing involves the obligation to repay. The trust deed creates a debt both in respect of principal and of interest, in the case of interest on each date when it becomes due. The fact that the covenant "points out the fund out of which payment shall be made . . . does not make the raising of that fund a condition precedent to the liability" of the company: Cf. *Pilbrow v. Pilbrow's Atmospheric Railway and Canal Propulsion Co.* (1). It is not a case of *solvendum nunquam*, as ultimately all overdue interest is payable out of the proceeds of realization. It is a liability incurred: Cf. *West Ham Corporation v. Grant* (2). "Outgoings," in my opinion, include payments made and liabilities incurred within the meaning of s. 51. In a case where a taxpayer keeps his accounts on a cash basis, different considerations might arise.

I therefore answer the question submitted in the affirmative on ground *a*.

STARKE J. The appellant, the taxpayer, issued £267,064 5 per cent irredeemable debenture stock secured by a trust deed. Stock certificates were issued which certified the registered holders of the stock and the amount of stock held, which stock, it was added, was "constituted and secured" by the trust deed. On their face, these certificates set forth that the interest was to be "a charge upon and payable only out of the net annual income" or, to use another phrase found in the certificates, "out of the net income of" the taxpayer "of each year" as "defined" and "provided" in the trust

(1) (1848) 5 C.B. 440, at p. 472 [136 E.R. 950, at p. 962].

(2) (1888) 58 L.J. Ch. 121.



deed, but the interest was not to be cumulative until after 31st December 1933. The interest as “defined” or “provided” in the trust deed refers back, I take it, to the provision in the trust deed that during the period of ten years ending on 31st December 1933 the interest shall be payable only out of the net income of the taxpayer from time to time available after payment of the interest upon certain  $4\frac{1}{2}$  per cent stock and after making all other provisions properly chargeable against revenue. Further, these certificates also set forth on their face that the stock was to be charged upon and rank *pari passu* with the  $4\frac{1}{2}$  per cent stock as a first charge upon all the property and assets of the taxpayer subject to a prior charge for securing the  $4\frac{1}{2}$  per cent stock upon certain specified property. The trust deed was made between the taxpayer and certain named trustees. It recited that it was part of the scheme referred to in the deed, that the 5 per cent stock should bear interest and be secured in manner and have the rights described in the stock certificates. And by the deed the taxpayer acknowledged that it was indebted to the trustees on behalf of the holders of the 5 per cent stock in the sum of £267,064 carrying interest at the rate of 5 per cent per annum payable half-yearly. And it was agreed that, until stock was redeemed or paid off, the taxpayer should pay the stock holders whose stock remained outstanding 5 per cent per annum as mentioned and provided in the stock certificates. Further, it was agreed that, during the period of ten years ending on 31st December 1933, the interest on the 5 per cent stock should be payable only out of the net income of the taxpayer from time to time available after payment of interest on the  $4\frac{1}{2}$  per cent stock and making proper provision for certain other outgoings and that after the expiration of such period the interest on the 5 per cent stock should be cumulative. And the trust deed also contained a covenant on the part of the taxpayer to pay to the trustees the amount of the 5 per cent stock and interest thereon in accordance with the terms set out in the third schedule (that is, in accordance with the terms and conditions set forth in the stock certificates on which the 5 per cent stock was issued) until repayment thereof but so that the trustees should receive the same as the trustees for the persons named in the stock certificates, who should be deemed to be the beneficial owners thereof. Further, the taxpayer by the trust deed charged in favour of the trustees by way of floating charge all the business, undertaking, property and assets of the taxpayer including its uncalled capital for securing payment of the  $4\frac{1}{2}$  per cent stock and 5 per cent stock respectively “and the interest thereon as aforesaid,” subject only to the prior charge in favour of the  $4\frac{1}{2}$  per cent stock already mentioned. The trust deed also contained a trust

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for sale upon the happening of various events, and the trustees were to hold the proceeds of realization, subject to certain preceding trusts, in and towards payment to the holders of the  $4\frac{1}{2}$  per cent stock and the 5 per cent stock equally in proportion to the respective amounts thereof due to them respectively and all arrears of interest thereon. And, upon the trustees being satisfied that the  $4\frac{1}{2}$  per cent and the 5 per cent stock and all interest thereon respectively had been paid, they were to re-convey the premises or so much thereof as remained vested in them. Further, the trust deed provides for the creation of a fund for redeeming the  $4\frac{1}{2}$  per cent and 5 per cent stock after paying or providing for the interest on the  $4\frac{1}{2}$  per cent stock and the 5 per cent stock. And, finally, there is a general covenant in the trust deed on the part of the taxpayer duly to perform and observe the obligations imposed upon it by the trust deed.

Interest on the 5 per cent stock calculated at 5 per cent for the twelve months ending on 31st December 1939 amounted in round figures to £13,333, but no part of that sum was during the period of twelve months nor since paid or credited to the trustees or any holders of the stock.

The taxpayer claims that this sum should be allowed as a deduction in its assessment to income tax for the financial year 1940-1941 based upon the income year 1939. The claim is based upon s. 51 of the *Income Tax Assessment Act 1936-1940*, which, so far as material, is as follows :—“(1) 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.” But the Commissioner of Taxation rejected the claim and disallowed the deduction. And he contends that the sum claimed was not an outgoing expended in the income year or at all. But the words of the section are not losses or outgoings expended or paid, but incurred, which is an appropriate enough word to cover liabilities to which taxpayers become liable or subject.

The section, however, requires that the liability shall be incurred in gaining or producing the assessable income or in carrying on a business for that purpose. And the Commissioner contends that the sum claimed by the taxpayer was not so incurred, in other words, that the taxpayer incurred no liability in the relevant year—1939—for the interest because it was payable only out of the net income of the company for that year. Net income of the taxpayer is not, I may observe, the same sum as its taxable income, which is the amount remaining after deductions from the assessable income of all allowable deductions. Admittedly there was no income available



in the relevant year for payment of the interest but a loss, as appears by the balance sheet and profit and loss account of the taxpayer. Consequently, it is said that the taxpayer incurred no liability and came under no obligation in the relevant year to pay the interest claimed as a deduction. The Commissioner is, I think, right in this contention. The terms and conditions of the stock certificates explicitly provide that the interest is to be payable only out of the net income of the taxpayer of each year as defined or provided in the trust deed. And the trust deed itself provides, as already mentioned, that the 5 per cent stock should have the rights described in the third schedule, that is, in the stock certificates ; that interest should be paid to stock holders as mentioned and provided in the schedule ; that the taxpayer will pay to the trustees the amount of 5 per cent stock and interest thereon in accordance with the terms set out in the schedule. It is said, however, that the taxpayer acknowledged its indebtedness to the trustees on behalf of the holders of the 5 per cent stock in the sum of £267,064 bearing interest at the rate of 5 per cent per annum. But that is consistent with the terms and conditions of the stock certificates that the interest shall be paid out of net annual income. Again, it is said that the clause providing that, during the period of ten years ending on 31st December 1933, interest shall be payable only out of net income after certain obligations have been provided for and thereafter shall be cumulative necessarily imports an obligation on the part of the taxpayer after the ten-year period to pay interest on the 5 per cent stock. But the real purpose of the provision is to provide when and when not the interest should be cumulative. Clearly this clause contains no express provision to pay interest after the ten-year period, and the implication contended for is by no means necessary having regard to the explicit term of the stock certificates and other clauses of the stock certificates. Finally, it is said that the 5 per cent stock and interest thereon, subject to a certain prior charge, is charged upon the capital assets of the appellant by way of floating charge, that is, upon the business, undertaking, property and assets of the taxpayer, including uncalled capital. This argument is, I think, correct ; the charge is to secure both the principal and interest on the 5 per cent stock and it is a charge upon capital assets. But a charge upon the capital assets of the taxpayer does not result in an outgoing incurred in gaining or producing assessable income or in carrying on business for that purpose. The charge is a security but only a security in case of non-payment of the principal or in case interest is not provided in the manner contemplated and agreed upon by the parties to the trust deed.

The question stated should be answered in the negative.

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MCTIERNAN J. The question to be decided is whether a sum of £13,333 13s. 6d. should be allowed as a deduction from the taxpayer's assessable income derived in the accounting period ended 31st December 1939. The deduction is claimed under s. 51 of the *Income Tax Assessment Act* 1936-1940 on the ground that the sum was an outgoing incurred in gaining or producing the assessable income. The sum of £13,333 13s. 6d. is the interest for twelve months ending 31st December 1939 upon the capital of "the five per cent Stock" which is described in the debenture trust deed made on 7th April 1925. No part of the amount was paid or credited to the holders of the stock.

In *Amalgamated Zinc (De Bavay's) Ltd. v. Federal Commissioner of Taxation* (1), Dixon J., speaking of the phrase "incurred in gaining or producing the assessable income" in s. 23 (1) (a) of the *Income Tax Assessment Act* 1922-1934, said that a very wide application should be given to it. His Honour said: "But the words refer to the assessable income from which the deduction is to be made. In a continuing business, items of expenditure are commonly treated as belonging to the accounting period in which they are met. It is not the practice to institute an inquiry into the exact time at which it is hoped that expenditure made within the accounting period will have an effect upon the production of assessable income and to refuse to allow it as a deduction if that time is found to lie beyond the period. And, in the case of expenditure for which the taxpayer contracted a liability during an earlier accounting period than that in which it has matured, it is not the practice to consider whether its effect upon the production of income of a still continuing undertaking has already been exhausted. The terms of s. 23 (1) (a) have never been understood as requiring such a thing (See *Ward & Co. Ltd. v. Commissioner of Taxes* (2) and *Herald and Weekly Times Ltd. v. Federal Commissioner of Taxation* (3)). The expression 'in gaining or producing' has the force of 'in the course of gaining or producing' and looks rather to the scope of the operations or activities and the relevance thereto of the expenditure than to purpose in itself" (4). See also *W. Nevill & Co. Ltd. v. Federal Commissioner of Taxation* (5). It follows from these principles that it was not necessary for the allowance of the deduction that the taxpayer should have paid the sum of £13,333 13s. 6d. in discharge of its liability for interest in the accounting period in which it received the income on which the assessment is based. But in the case of *Jolly v. Federal Commissioner of Taxation* (6), Dixon J., in disallowing a claim for the allowance of a

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

(2) (1923) A.C. 145, at p. 148.

(3) (1922) 48 C.L.R. 113, at p. 118.

(4) (1935) 54 C.L.R., at p. 309.

(5) (1937) 56 C.L.R., at p. 305

(6) (1934) 50 C.L.R. 131.



deduction for interest under the relevant section of an earlier Act, said : “ Although he paid nothing for interest during the two years in question, the taxpayer claims that a deduction should be allowed under s. 18 (1) (a) of the *Income Tax Assessment Act* 1915-1921, and that it should be considered money wholly and exclusively laid out or expended for the production of income within s. 20 (e). Whatever arrangement was made by the taxpayer with the executors of Widdis, I am not satisfied that it imposed upon him a liability to pay interest within either of the two years ending 30th June 1920 or 1921. I am not prepared to find that the taxpayer incurred an obligation which in those two years resulted in a debt for interest then due and payable. I do not think a deduction can be obtained unless an immediate liability accrued within the accounting period, there being no actual expenditure. Upon that ground I disallow the claim ” (1).

The question that arises is therefore whether the taxpayer incurred an obligation which in the accounting period ending 31st December 1939 resulted in a debt for interest which was then due and presently payable. In my opinion, it did not incur an obligation of that nature. The answer to the question is governed by the debenture trust deed made on 7th April 1925. The case stated shows that the taxpayer made a loss for the year ended 31st December 1939.

On the one hand, the taxpayer contends that the proper construction of the deed is that it imposes an absolute liability upon the taxpayer to pay the interest on the above-mentioned stock on 1st April and 1st October in each year and merely makes the net income the primary fund for the payment of such interest. On the other hand, the Commissioner contends that the proper construction of the deed is that the terms upon which the taxpayer in the year ended 31st December 1939 incurred any obligation under the deed to pay interest on such stock, limited the rights of the trustees or the holders to payment of the interest out of the net income and that the earning of net income and its sufficiency to meet the interest constitute a condition precedent to liability for such interest. The nature of the question which these contentions raise is stated in *Halsbury's Laws of England*, 2nd ed., vol. 7, p. 221 (p) in these terms : “ In the case of contracts for payment out of a particular fund, it is a matter of construction whether it is a condition precedent that such fund should furnish the means of payment, or whether the fund is indicated merely as that out of which the money is primarily to come.” The Commissioner's contention is in my opinion the correct one.

The liability to pay interest on the 5 per cent stock is at several places in the deed declared to be subject to the conditions mentioned

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in the third schedule. The provisions of the deed and the schedule are lengthy and I do not repeat them. Reading them together, the conclusion at which I arrive is that the company, the taxpayer, did not make an absolute promise to pay interest in the year ended 31st December 1939 on the stock ; the promise which it made was to pay interest in that year only out of the net annual income of the company. As there was no such fund in the year ended 31st December 1939, the taxpayer was not under an obligation resulting in a debt due and payable in that year to pay interest on the 5 per cent stock.

In my opinion, the question in the case stated should be answered :  
No.

WILLIAMS J. The case stated raises the question whether in calculating the taxable income of the appellant company for the purposes of Federal income tax in respect of the financial year 1940-1941 the sum of £13,333 13s. 6d. should be allowed as a deduction from its assessable income upon the ground that this sum was an outgoing incurred in gaining or producing the assessable income within the meaning of s. 51 of the *Income Tax Assessment Act* 1936-1940. This sum represented the interest at the rate of 5 per cent per annum on £266,673 irredeemable debenture stock issued by the appellant pursuant to the provisions of a trust deed dated 7th April 1925 which accrued due during the accounting period, namely, the twelve months ending 31st December 1939, adopted by the appellant and accepted by the respondent as the year of income for the purpose of calculating its assessable income for the financial year in question.

The circumstances leading up to the execution of the trust deed are set out in the case stated and in the recitals to the deed and I need not re-state them. The deed was made between the appellant of the one part and the trustees of the other part and relates to the issue of  $4\frac{1}{2}$  per cent irredeemable debenture stock limited to £130,900 and of 5 per cent irredeemable debenture stock limited to £267,064. It incorporates a number of the provisions contained in an earlier indenture dated 11th July 1899 referred to as the "principal Indenture". These provisions, which include, *inter alia*, the events upon which the power of sale vested in the trustees under clause 16 of the trust deed becomes exercisable, do not form part of the case, but the Court has been informed that they are not relevant to the determination of the case and that the principal indenture contains certain detailed provisions relating to the exercise by the trustees of their powers and other matters of a purely administrative or machinery kind. As the Court is called upon to construe the trust



deed in order to answer the questions asked, I should have preferred that the whole and not some of its provisions should have been placed before the Court and I should have liked to know at least what these events are.

The appellant is a company which carries on in Tasmania the business of operating certain railways. The general nature of irredeemable debenture stock issued by a company operating a public utility, whether it is a railway, canal, bridge, dock or any other form of public utility, has been discussed in several cases. The interest and the capital of the debt are usually but not invariably charged on the undertaking of the company, the interest being made payable, whilst the company is a going concern, only out of the net earnings of the company, but also being made a prior charge on the assets of the company if any event, such as liquidation, should occur to put the company out of business: *In re Glyn Valley Tramway Co.* (1). While the company continues to carry on the business, the charge of the undertaking is construed to be a charge of the undertaking as a going concern, so that, although the trustees for the stock holders may be entitled to appoint a receiver of the net revenue if the interest falls into arrears, the receiver is not appointed, like an ordinary receiver, to manage and carry on the business of the company, but is more in the nature of a treasurer appointed to receive the revenue and make the disbursements in their proper order as the revenue comes in from the carrying on by the company of its business. See *Attree v. Hawe* (2). In *Gardner v. London Chatham and Dover Railway Co.* [No. 1] (3) Lord Cairns said:—"The undertaking, so far as these contracts of mortgage are concerned, is, in my opinion, made over as a thing complete or to be completed; as a going concern, . . . as a fruit-bearing tree, the produce of which is the fund dedicated by the contract to secure and to pay the debt. The living and going concern . . . must not, under a contract pledging it as security, be destroyed, broken up, or annihilated. The tolls and sums of money *ejusdem generis*—that is to say, the earnings of the undertaking—must be made available to satisfy the mortgage; but, in my opinion, the mortgagees cannot, under their mortgages, or as mortgagees—by seizing, or calling on this Court to seize, the capital, or the lands, or the proceeds of sales of land, or the stock of the undertaking—either prevent its completion, or reduce it into its original elements when it has been completed" (4).

In the same case, *Turner* L.J. said:—"It may be asked why the undertaking was assigned by the debenture, if the security was to be

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(1) (1937) Ch. 465, at pp. 470, 471.

(2) (1878) 9 Ch. D. 337, at p. 348.

(3) (1867) L.R. 2 Ch. App. 201.

(4) (1867) L.R. 2 Ch. App., at p. 217.



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limited to the funds of the undertaking only. This question admits, I think, of a very ready answer. The assignment of the undertaking was necessary for the protection of the debenture creditors against other claimants upon the property of the company" (1).

In *Attree v. Hawe* (2), James L.J., in delivering the judgment of the Court of Appeal, said in a case where there was no conveyance or assignment of anything to the stock holder or to any trustee for him: "There is no debt, except, indeed, as to the annual interest; the capital cannot be called in, and cannot be paid off" (3). Later he said: "The result is that the debenture stock is a charge upon the net profits and earnings of a trading corporation, and is no more land, tenement, or hereditament, or any interest in land, tenement, or hereditament, or charge or incumbrance affecting land, tenement, or hereditament, than the share stock in such corporation is, or a bond or other debt due from a man who has got real property is" (4).

In *Cross v. Imperial Continental Gas Association* (5), where again there was no assignment, Romer J. (as he then was), after referring to the judgment of the Court of Appeal in *Attree v. Hawe* (2), said: "It follows that the debenture stock did not constitute a specific charge upon the German property, and that, in as much as no interest upon it is in arrear, there is no debt due to the debenture stockholders" (6).

The trust deed in the present case expressly provides for the creation of two charges over the assets of the appellant in favour of the holders of the  $4\frac{1}{2}$  per cent and the 5 per cent stock. The holders of the  $4\frac{1}{2}$  per cent stock have a prior charge over the assets referred to in the first schedule, and they share *pari passu* with the holders of the 5 per cent stock in the floating charge over the assets other than those comprised in the first schedule created by clause 10 of the trust deed. The trust deed contains in the second schedule the terms and conditions on which the  $4\frac{1}{2}$  per cent stock is to be issued and in the third schedule the terms and conditions on which the 5 per cent stock is to be issued. These schedules also contain provisions for the issue of stock certificates under the seal of the company to the holders of each class of stock, but these certificates do not contain any covenant between the appellant and each individual stockholder, so that the contractual relations existing in respect of each class of stock are contained in the trust deed, the parties to the contract being the appellant and the trustees: *In re Dunderland Iron Ore Co. Ltd.* (7).

The second schedule states that the  $4\frac{1}{2}$  per cent stock and interest is to be a first charge on all the property described in the first schedule

(1) (1867) L.R. 2 Ch. App., at p. 222.

(2) (1878) 9 Ch. D. 337.

(3) (1878) 9 Ch. D., at p. 349.

(4) (1878) 9 Ch. D., at p. 351.

(5) (1923) 2 Ch. 553.

(6) (1923) 2 Ch., at p. 564.

(7) (1909) 1 Ch. 446.



and that the stock (a specific reference to interest is omitted) is also to be a charge on the other property and assets for the time being of the company ranking *pari passu* with the 5 per cent stock. The third schedule states that the 5 per cent stock (there is again no specific reference to interest) is to be charged and rank *pari passu* with the  $4\frac{1}{2}$  per cent stock as a first charge upon all the property and assets of the company subject only to the prior charge for securing the  $4\frac{1}{2}$  per cent stock on the property described in the first schedule thereto including a certain leasehold interest but is to rank *pari passu* with the  $4\frac{1}{2}$  per cent stock on the other property of the company. But each class of stock confers upon its holders a right to the payment of both principal and interest, so that a charge of the stock on the company's assets without any express reference to interest would include a charge to secure both principal and interest, and it must have been intended that the  $4\frac{1}{2}$  per cent stock holders would have the same charge for interest over the property referred to in clause 10 of the trust deed as they have over the property comprised in the first schedule. But any doubt is removed by the provisions of the trust deed itself, which expressly charge the assets of the company with the capital and interest owing on both classes of stock and clause 16 expressly provides, in the event of a sale, for the payment of arrears of interest out of the proceeds of sale. Clause 11 refers to the interest on the 5 per cent stock so far as the same shall be payable, but in the context of the whole of the trust deed, these words must relate, in my opinion, to the rights of the 5 per cent stock holders during the period of ten years ending 31st December 1933.

Clause 7 of the trust deed provides that "during the period of ten years ending on the 31st of December 1933 the interest on the 5 per cent stock shall be payable only out of the net income of the company from time to time available after payment of the interest upon the  $4\frac{1}{2}$  per cent stock and after making proper provision for the upkeep of the company's railways rolling stock workshops buildings plant and tools including the setting aside of reasonable sums for depreciation and after paying the company's directors fees and the remuneration of the Trustees and discharging all other outgoings and making all other provisions properly chargeable against revenue and necessary to secure the efficient maintenance and working of the said railways and after the expiration of such period the interest on the 5 per cent stock shall be cumulative. In the event of any question dispute or difference arising at any time between the company and the trustees as to the amount of the net income of the company available as aforesaid at the close of any half-year ending on the 30th of June or the 31st of December in any year or as to there being none the same shall be

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referred to the arbitration and final decision of a single arbitrator resident in the State of Victoria to be agreed upon by the parties or failing agreement to be nominated by the President for the time being of the Institute of Chartered Accountants in England whose decision or award shall be conclusive and this provision shall be deemed to be a submission to arbitration within the meaning of and subject to the provisions of the English *Arbitration Act* 1889 or any statutory modification or re-enactment thereof for the time being in force." The third schedule provides that "the interest is to be at the rate of £5 per centum per annum as from the 31st day of December 1923 and is to be payable half-yearly on the 1st day of April and the 1st day of October in each year the first payment for the period from the 31st day of December 1924 to 30th day of June 1924 to be made on 1st day of October 1924. The interest is to be a charge upon and payable only out of the net annual income of the company as defined in the trust deed subject to the prior charge thereon of the interest upon the  $4\frac{1}{2}$  per cent stock. The interest is not to be cumulative until after the 31st day of December 1933." If clause 7 stood alone, it might be open to argument that the limitation of the right to receive payment of the 5 per cent interest to a charge upon what is defined as the net income of the appellant is confined to the period of ten years ending on 31st December 1933. But the covenant in clause 11 of the trust deed is quite explicit that the obligations of the appellant with respect to payment of the amount of the 5 per cent stock and interest thereon are set out in the third schedule, and that schedule clearly provides that the interest is to be a charge upon and payable only out of the net annual income of the appellant as defined in the trust deed, subject to the prior charge thereon of the interest payable upon the  $4\frac{1}{2}$  per cent stock and that the interest is not to be cumulative until after 31st December 1933. When clause 11 of the trust deed and the relevant provisions of the third schedule are read together, it becomes apparent, I think, that the main purpose of clause 7, though it is somewhat inartistically worded, is to define the net income of the appellant on which the interest on the 5 per cent stock is charged and out of which it is payable. The clause states that, during the period of ten years, the interest on the 5 per cent stock shall be payable only out of the net income of the company, but it is here referring, I think, to the period during which the interest, so far as there is no net income available to pay it, is not to be cumulative. The third schedule, in dealing with the rights of the 5 per cent stock holders, is quite specific that the interest is to be payable only out of the net annual income of the company, and the statement in the clause that, after the expiration of the period of ten years, the



interest shall be cumulative in itself implies that it is to be payable out of an annual fund which may be insufficient to meet it. The second limb of the clause provides for the reference to arbitration of disputes as to the amount of the net income of the company at the close of any half-year ending on 30th June or 31st December in any year, so that this limb is unlimited in point of time. There is also the strong presumption, arising from the nature of the appellant's business, that the interest should be in the nature of an annuity payable out of the profits of the concern.

But the third schedule consists of two paragraphs, the first of which relates to the payment of the interest out of the net income of the appellant, while the second relates to the charge of the interest, so far as it is cumulative and is not discharged out of the net income, upon the assets of the appellant, and the statement in that schedule that the interest is to be payable only out of the net annual income of the company is insufficient, in my opinion, to prevent arrears of interest calculated at 5 per cent per annum which accrue due and are not paid from that source from becoming charged on the company's assets.

Upon the whole context of the trust deed, including the third schedule, the conclusion I have reached is that the agreement between the appellant and the trustees is that, during the period ending on 31st December 1933, the 5 per cent interest is only to be paid in each year so far as there is, in that year, net income of the appellant available to pay it, but that, after 31st December 1933, while the interest in any year is only payable in that year to the extent to which there is such net income, if the net income is insufficient for this purpose any balance which remains unpaid will accumulate and be payable out of the net income of any subsequent year to the extent to which that income is sufficient for the purpose, and any balance of interest which has accrued due and remains unpaid becomes charged upon the assets of the appellant and the trustees are secured creditors for the arrears of interest, so that, in the event of the company going into liquidation or upon a sale by the trustees of the assets upon the happening of one of the events provided for in clause 16, whatever these events may be, these arrears will be recoverable out of the assets of the company.

The accounts of the appellant for the year ending 31st December 1939 show that its revenue for that year was £98,379 3s. 4d., and that, after allowing for traffic expenses, maintenance, management, repairs, office expenses, &c., £77,599 17s. 4d.; rates and taxes including income taxes £3,206 6s. 11d.; interest £811 19s.; depreciation £8,754 16s. 7d.; provision for upkeep of rolling stock &c. £700; a

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balance to be carried down remained of £7,306 3s. 6d., to which there was added a balance as at 31st December 1938 of £79 16s. 7d., making the total to the credit of Profit and Loss Account of £7,386 0s. 1d., out of which £5,890 10s. and provisions for exchange £1,479 2s. 7d. was required to pay the interest on the  $4\frac{1}{2}$  per cent stock for the year, leaving a balance of £16 7s. 6d. The case states that, for the twelve months ending on 31st December 1939, the appellant incurred a loss of £63 as appears from its Profit and Loss Account annexed to its return for income tax; that for the same period its taxable income, if the deduction of £13,333 13s. 6d. is not allowed, was £6,675; and that, for the purpose of the assessment of the appellant to income tax for the financial year 1940-1941, the respondent assessed the appellant upon a taxable income of £6,675 and issued a notice of assessment claiming that the sum of £751 5s. was payable in respect of such income tax. The case does not explain how a loss of £63 is converted into a taxable income of £6,675, but I assume that this results from adjustments by way of diminution of the amounts charged against revenue in the Profit and Loss Account, and we were told during the hearing that the amount of taxable income was arrived at after allowing as a deduction the amount paid for interest but not the amount paid for exchange on the  $4\frac{1}{2}$  per cent stock. The case also states that no part of the sum of £13,333 13s. 6d. was, during the twelve months ending 31st December 1939, or has since been paid or credited to any holders of the 5 per cent stock.

Section 51 of the *Income Tax Assessment Act* 1936-1940 provides, so far as material, that all outgoings to the extent to which they are incurred in gaining or producing the assessable income shall be allowable deductions except to the extent to which they are losses or outgoings of capital. It has not, and could not, I think, be suggested in the present case that the debt of £13,333 13s. 6d. if it was incurred in the accounting period, was not incurred in gaining or producing the assessable income or that it was an outgoing of capital, but counsel for the respondent has raised two contentions with respect to the section. The first contention is that the liability to pay interest on the 5 per cent stock in the accounting period was confined to the net income as defined by clause 7 of the trust deed available to meet it, and that, as there was only £16 7s. 6d. available for this purpose, the amount of the outgoing incurred in the accounting period was not £13,333 13s. 6d. but £16 7s. 6d. or, in substance, nil. The second contention is that, even if the appellant incurred a liability of £13,333 13s. 6d. in the accounting period, it did not discharge any part of that liability and the outgoings that can be deducted under the section are liabilities that have been actually discharged during



the accounting period. I cannot agree with the second contention. Outgoings, which is a word of the widest import, must include debts. A taxpayer incurs a debt when it becomes due and owing, although it may not be immediately payable, so that debts incurred during the year of income are outgoings incurred in that year within the meaning of the section whether they are paid or payable in that period or not : *West Ham Corporation v. Grant* (1).

As *Luxmoore* L.J. said in *Absalom v. Talbot* (2) :—" In ordinary parlance ' debt ' is the proper description to be applied to money which is owing and remains unpaid, whether the due date of payment has arrived or not, as witness the well-worn phrase '*debitum in praesenti solvendum in futuro*'." Cf. *Naval Colliery Co. (1897) Ltd. v. Inland Revenue Commissioners* (3) ; *Inland Revenue Commissioners v. Bagnall Ltd.* (4) ; cf. also per *Latham C.J.* in *W. Nevill & Co. Ltd. v. Federal Commissioner of Taxation* (5) ; per *Dixon J.* in *Elder Smith & Co. Ltd. v. Commissioner of Taxation (N.S.W.)* (6) and *New Zealand Flax Investments Ltd. v. Federal Commissioner of Taxation* (7).

The substantial question is, therefore, whether the appellant incurred in the accounting period a debt of £13,333 13s. 6d. or only incurred a debt to the extent to which it became liable to pay this sum as a going concern out of the net income for the year ending 31st December 1939. If the whole liability for the interest, although amounting to £13,333 13s. 6d., was entirely confined to the net income of that year, so that, to the extent to which that income was insufficient to meet it, that liability was discharged, then the amount of the outgoings would no doubt be the amount of the net income ; but the liability for the interest is not discharged in this manner, and the interest, to the extent to which it is not met, remains an actual debt due and owing by the appellant and charged on its future net income and its assets, although it is only payable in the particular ways already mentioned. It is apparent, I think, from the principles stated in the authorities which I have cited that, as each half-yearly payment of interest on the stock becomes due and owing, it creates a debt and the trustees become and remain secured creditors of the appellant for that amount of interest until it is paid.

Counsel for the respondent also contended that the trust deed on its true construction only conferred upon the holders of the 5 per cent stock a right to share in the distribution of the profits of the company to the extent to which interest had accrued due in the relevant period, and that this was a provision for payment out of taxable

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(1) (1888) 58 L.J. Ch. 121.

(2) (1943) 1 All E.R. 589, at p. 600.

(3) (1928) 138 L.T. 593, at p. 596.

(4) (1944) 1 All E.R. 204.

(5) (1937) 56 C.L.R. 290, at p. 302.

(6) (1932) 47 C.L.R. 471, at p. 478.

(7) (1938) 61 C.L.R. 179, at p. 207.



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profits as distinguished from payment prior to the ascertainment of those profits. He relied on the decision of this Court in *Commissioner of Taxation (W.A.) v. Boulder Perseverance Ltd.* (1). The cases on this sort of question up to that date are collected in the report (2), and I shall simply add, in order to bring the matter up to date, that, as counsel pointed out, the case of *British Sugar Manufacturers Ltd. v. Harris* (3) has since been reversed (4), and that there is a recent decision on the same subject matter: *Utol Ltd. v. Inland Revenue Commissioners* (5). But the present case is, in my opinion, completely distinguishable from the *Boulder Perseverance Case* (1) on its facts. The 5 per cent stock holders are not entitled to any share in the profits of the company. They are entitled to interest on their money to be paid in a particular manner. So far as there is any analogy to that case, however distant, they are more in the position of the holders of the profit-sharing notes in respect of the ten per cent interest, which was admittedly a deduction from the assessable income.

For these reasons, I would answer the question asked in the affirmative on ground *a* and it then becomes unnecessary to deal with ground *b*.

*Question in case answered (a) No; (b) No.  
Costs of case to be costs in appeal. Case  
remitted to Starke J.*

Solicitors for the appellant, *Blake & Riggall*.

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

E. F. H.

(1) (1937) 58 C.L.R. 223.

(2) (1937) 58 C.L.R., at p. 233.

(3) (1937) 3 All E.R. 702.

(4) (1938) 2 K.B. 220.

(5) (1944) 1 All E.R. 190.