[HIGH COURT OF AUSTRALIA.]

AMERICAN THREAD COMPANY . . . APPELLANT;

AND

FEDERAL COMMISSIONER OF TAXATION . RESPONDENT.

H. C. OF A. 1946.

MELBOURNE, *Oct.* 29, 30; *Dec.* 20.

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

Income Tax (Cth.)—Assessment—Assessable income—Deduction—Losses of previous years—Business carried on partly in and partly out of Australia—Loss incurred in one year—Profit in ensuing year—Income Tax Assessment Act 1936-1943 (*No.* 27 *of* 1936—*No.* 10 *of* 1943), *ss.* 38-43, 80.

Part III., Div. 2, Sub-div. *C* (ss. 38-43, relating to the income of businesses carried on partly in and partly out of Australia), of the *Income Tax Assessment Act* 1936-1943 does not exclude from the operation of s. 80 (providing for the deduction from assessable income of losses of previous years) losses incurred in a prior year by a trader who, if he had made profits in that year, would have been liable to have them ascertained under Sub-div. *C*.

CASE STATED.

On an appeal to the High Court by the American Thread Co. from an assessment to Federal income tax *Rich* J. stated for the opinion of the Full Court a case which was substantially as follows:—

1. The American Thread Co. (hereinafter called "the taxpayer") is a company incorporated in Scotland, where it carries on the business of manufacturing thread. It is not a resident of Australia within the meaning of the *Income Tax Assessment Act* 1936-1943.

2. At all material times the taxpayer imported into and sold in Australia through its agent, Central Agency (Aust.) Ltd., goods manufactured by the taxpayer in Scotland, but, apart from the profits from such sales and a small amount of interest, the taxpayer derived no income directly or indirectly from sources in Australia.

3. The taxpayer made a return in the form of a profit and loss account of the income derived by it during the accounting period ended 31st December 1941, which, under s. 18 of the Act, was the accounting period adopted in lieu of the year of income ended 30th June 1942. The account was as follows:—

Profit and Loss Account (Australian Business) for the Year Ended 31st December 1941.

1941		£ Sterling			1941		£ Sterling		
Jan. 1	To Stock on Hand and Goods in Transit	10,441	3	3	Dec. 31	By Gross Sales	21,965	12	1
Dec. 31	,, Goods invoiced for year ..	20,204	4	9		,, Interest	9	0	0
	,, Freight, Insurance and Duty applicable to Sales ..	5,001	4	2		,, Stock on Hand and Goods in Transit	14,626	17	3
	,, Discounts to Customers ..	918	1	4		,, Balance being Net Loss for the Year Ended 31st December 1941..	3,031	2	10
	,, Bad Debts written off ..	33	0	0					
	,, Difference in Exchange ..	12	5	2					
	,, Selling Expenses and Administration—								
	Federal Income Tax .. 117 13 6								
	State Income Tax .. 96 0 6								
	Special Income Tax .. 15 8 5								
	Undistributed Profits Tax 117 13 6								
	General Expenses.. 2,675 17 7								
		3,022	13	6					
		£39,632	12	2			£39,632	12	2

The case gave the following explanations of items in the account :— The item " Gross Sales " represents the proceeds of the sale (before allowing for discount) of goods manufactured by the taxpayer in Scotland and sold by it in Australia during the accounting period. The item " Goods invoiced for year " represents the amount for which at the date the goods were shipped to Australia goods of the same nature and quality could be purchased by a wholesale buyer in Scotland. The items " Freight, Insurance and Duty applicable to Sales," " Discounts to Customers," " Difference in Exchange " and the item " Selling Expenses and Administration " (to the extent of £2,183 sterling) represent the expenses incurred during the accounting period ended 31st December 1941 in transporting the goods to and selling them in Australia. The sum of the items " Gross Sales," " Interest " and " Stock on Hand and Goods in Transit " (as at 31st December 1941) is less than the sum of the items " Stock on Hand and Goods in Transit " (as at 1st January 1941) and " Goods invoiced for year " and the expenses incurred during the accounting period ended 31st December 1941 in transporting the goods to and selling them in Australia and the amount of bad debts written off during the said period by an amount of £2,192 sterling, which, converted at the rate of £125 10s. Australian currency to £100 sterling, and expressed in Australian currency, is £A2,752.

4. The taxpayer made a similar return of the income derived by it during the accounting period ended 31st December 1942, the account being as follows :—

Profit and Loss Account (Australian Business) for the Year Ended 31st December 1942.

1942		£ Sterling			1942		£ Sterling		
Jan. 1	To Stock on Hand and Goods in Transit	14,626	17	3	Dec. 31	By Gross Sales	24,267	3	9
Dec. 31	,, Goods invoiced for year ..	21,980	14	6		,, Interest	4	0	0
	,, Freight, Insurance and Duty applicable to Sales ..	5,112	17	0		,, Stock on Hand and Goods in Transit	23,458	19	9
	,, Discounts to Customers ..	1,671	4	5					
	,, Bad Debts written off ..	13	0	0					
	,, Difference in Exchange ..		3	7					
	,, Selling Expenses and Administration—								
	Federal Income Tax .. 465 2 9								
	State Income Tax .. 123 18 5								
	War-Time (Company) Tax 257 19 1								
	General Expenses.. 2,975 1 0								
		3,822	1	3					
	,, Balance being Net Profit for the Year Ended 31st December 1942	503	5	6					
		£47,730	3	6			£47,730	3	6

The case explained the items " Gross Sales " and " Goods invoiced for year " as in par. 3 above, and proceeded :—The items " Freight, Insurance and Duty applicable to Sales," " Discounts to Customers," " Difference in Exchange " and the item " Selling Expenses and Administration " (to the extent of £2,419 sterling) represent the expenses incurred during the accounting period ended 31st December 1942 in transporting the goods to and selling them in Australia. The sum of the items " Gross Sales," " Interest " and " Stock on Hand and Goods in Transit " (as at 31st December 1942) exceeds the sum of the items " Stock on Hand and Goods in Transit " (as at 1st January 1942) and " Goods Invoiced for year " and the expenses incurred during the accounting period ended 31st December 1942 in transporting the goods to and selling them in Australia and the amount of bad debts written off during the said period by an amount of £1,906 sterling. which, converted at the rate of £125 10s. Australian currency to £100 sterling, and expressed in Australian currency, is £A2,392.

5. The taxpayer contends that, in the assessment of its taxable income for the accounting period ended 31st December 1942 it is entitled, pursuant to s. 80 (2) of the *Income Tax Assessment Act*, to be allowed as a deduction the amount of £A2,392 (which, converted and expressed in sterling currency, is £1,906) being portion of the sum of £A2,752 referred to in par. 3 hereof.

6. By notice of assessment dated 30th August 1944 the respondent gave notice that he had assessed the taxable income of the taxpayer for the accounting period ended 31st December 1942 at £A2,392 and had disallowed the taxpayer's claim to be allowed the deduction aforesaid or any part thereof.

7. The taxpayer's objection to the assessment was disallowed and was treated as an appeal to the High Court.

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

> Is the taxpayer entitled to a deduction from its income derived during the said accounting period ended 31st December 1942 of the sum of £A2,392 or any and if so what portion of that sum as a loss pursuant to s. 80 of the said Act ?

Coppel K.C. (with him *Eggleston*), for the appellant. The transactions in question here are within Part III., Div. 2, Sub-div. *C*, of the Act to the extent, at least, that the taxpayer must make up an account according to the method prescribed by that sub-division in order to ascertain whether in a given year its transactions show a profit, which will be assessable income, or a loss, in which case there

H. C. OF A. 1946.

AMERICAN THREAD CO. v. FEDERAL COMMISSIONER OF TAXATION.

is no assessable income. The sub-division departs from the general scheme of the Act as to the ascertainment of assessable income in that it provides for the ascertainment of a net sum, whereas generally the assessable income is a gross sum from which deductions are made to arrive at the taxable income. In a year in which a profit is shown, the effect of s. 43 (2) is that no amount taken into account in ascertaining the profit in the manner prescribed by the sub-division is to be allowed as a deduction from the assessable income, but the sub-section does not exclude the application of the provisions of the Act generally as to allowable deductions. The sub-division is designed to prevent a double deduction; otherwise it does not affect the question of deductions. The position therefore is, on the assumption that the sub-division applies where there is a loss, that the loss has been ascertained by the method of accounting provided by the Act, and, in the absence of any provision excluding the operation of s. 80, that loss is necessarily one in respect of which s. 80 will have effect. The alternative view is that Sub-div. *C* has no application where a loss is incurred. In this view it would seem that the taxpayer must in the first instance take an account in the manner prescribed by the sub-division in order to ascertain whether there is a profit or a loss. A loss having been shown, the position would be, for the purposes of s. 80, that an account would have to be taken in accordance with the provisions of the Act generally (independently of Sub-div. *C*). In the case of the appellant, which is a non-resident, the account would have to discriminate between income derived in, and income derived outside, Australia. The question of the source of the income would be a question of fact to be determined in the particular case, no fixed rule or formula being practicable: Cf. *Michell* v. *Federal Commissioner of Taxation* (1). It may be that an account taken in accordance with Sub-div. *C* would not be altogether appropriate for the purposes of s. 80, but a method not unlike that provided by the sub-division would have to be used. As the Commissioner has taken no exception to the form of accounting adopted by the appellant, the figure shown may be taken as fairly representing the loss for the purposes of s. 80. In this view s. 43 (2) cannot, on any possible construction, be prejudicial to the appellant, and s. 80 (2) clearly entitles the appellant to the deduction claimed.

Tait K.C. (with him *Winneke*), for the respondent. Sub-div. *C* applies generally, in the case of residents as well as non-residents, in respect of the transactions to which it refers. Section 43 (1) contains words which are appropriate only where a profit is derived,

(1) (1927) 46 C.L.R. 413.

but the words of sub-s. (2) are wider and cover all possible deductions in relation to transactions of the kind described in the sub-division. The whole scheme of the sub-division, departing as it does from the general scheme of the Act, is opposed to the application of the general provisions as to deductions to cases in which the assessable income is ascertained on an entirely different basis. In view of s. 43 (2), the language of s. 80 (1) is inconsistent with the appellant's claim. If s. 80 has any application at all where, as in the present case, there is no net income, it is, nevertheless, applicable only where there are " allowable deductions" which exceed the sum of the assessable income. The language of s. 43 (2) is specific that no expenditure incurred in relation to sales to which Sub-div. *C* applies shall be an allowable deduction. The foundation of the appellant's contention is that such expenditure is an " allowable deduction " within the meaning of s. 80 (1), but this construction is precluded by the express words of s. 43 (2).

Coppel K.C., in reply.

Cur. adv. vult.

Dec. 20.

The following written judgments were delivered :—

LATHAM C.J. Case stated under the *Income Tax Assessment Act* 1936-1943 and s. 18 of the *Judiciary Act* 1903-1946.

Section 80 (2) of the Act provides that so much of the losses incurred by a taxpayer in any of the four years next preceding the year of income as has not been allowed as a deduction from his income of any of those years shall be allowable as a deduction in accordance with the provisions of the section. The company claims that in the income year ending 31st December 1941 (which was the accounting period for the company under s. 18 of the Act) it incurred a loss and that that loss is allowable as a deduction from the income of the subsequent year 1942. The Commissioner, on the other hand, contends that s. 80 is not applicable because the company was in each of the years mentioned subject to the provisions of Sub-division *C* of Division 2 of Part III. of the Act, and under those provisions there were no allowable deductions which exceeded the sum of the income of the company during the year 1941 within the meaning of s. 80 (1), so that there was no loss within the meaning of that sub-section which could be deducted under s. 80 (2).

The company is a company incorporated in Scotland and is a non-resident within the meaning of the Act (see s. 6, definitions of " non-resident " and " person ") and therefore its assessable income prima facie includes the gross income derived directly or indirectly from all

H. C. OF A. 1946.

AMERICAN THREAD CO. v. FEDERAL COMMISSIONER OF TAXATION.

Latham C.J.

sources in Australia which is not exempt income (s. 25 (1) (*b*)). The company, however, manufactures goods in Scotland which it sends to Australia and sells in Australia. Accordingly the provisions of Sub-division *C* of Division 2, Part III., of the Act are applicable for the purpose of ascertaining what profit is deemed to be derived by the company in Australia. This sub-division applies to businesses carried on partly in and partly out of Australia. Section 38 is as follows :—

" Where goods manufactured out of Australia are imported into Australia and the goods are, either before or after importation, sold in Australia by the manufacturer of the goods, the profit deemed to be derived in Australia from the sale shall be ascertained by deducting from the sale price of the goods the amount for which, at the date the goods were shipped to Australia, goods of the same nature and quality could be purchased by a wholesale buyer in the country of manufacture, and the expenses incurred in transporting them to and selling them in Australia."

Section 43 is as follows :—

" (1) The assessable income of a taxpayer shall include any profit derived by him in the year of income which, under the provisions of this sub-division, is derived or deemed to be derived in Australia and the proceeds of any sale to which this sub-division applies shall not otherwise be included in his assessable income.

(2) No amount taken into account in ascertaining any such profit, and no expenditure incurred directly or indirectly in or in relation to any such sale, shall be an allowable deduction."

The result of the application of these sections is that a profit ascertained in accordance with their terms is included in the assessable income of the company.

For the year 1941 calculations which the parties have accepted as being made in accordance with the provisions of these sections brought out the result that there was a loss in Australian currency of £2,752. This loss was the result of taking into account on the one hand the gross sales of goods during the year, stock on hand and goods in transit at the end of the year, together with a small sum (£9) of interest. From this total amount deductions were made of the value of stock on hand and goods in transit at the beginning of the year, the value of the goods invoiced for the year, freight, insurance and duty applicable to sales, discounts to customers, bad debts, difference in exchange and that proportion of expenses which was referable to transporting the goods to and selling them in Australia. When adjustments were made by excluding taxes which were not

deductible for income tax purposes the result was, as stated, a loss for 1941 of £2,752.

In the following year upon an account taken in the same manner the result was a profit of £1,906. The company claims to deduct from this 1942 profit an amount of £1,906, representing so much of the 1941 loss as had not been allowed as a deduction in any preceding year.

This claim is based upon s. 80, the precise terms of which require careful attention. Section 80 is as follows :—

" (1) For the purposes of this section, a loss shall be deemed to be incurred in any year when the allowable deductions (other than the concessional deductions and the deduction allowable under this section) from the assessable income of that year exceed the sum of that income and the net exempt income of that year, and the amount of the loss shall be deemed to be the amount of such excess.

(2) So much of the losses incurred by a taxpayer in any of the four years next preceding the year of income as has not been allowed as a deduction from his income of any of those years shall be allowable as a deduction in accordance with the following provisions :—

(*a*) where he has not in the year of income derived exempt income, the deduction shall be made from the assessable income ;

(*b*) where he has in that year derived exempt income, the deduction shall be made successively from the net exempt income and from the assessable income ;

(*c*) where a deduction is allowable under this section in respect of two or more losses, the losses shall be taken into account in the order in which they were incurred."

Sub-section (3) of s. 80 contains a definition of " net exempt income " which in the case of a non-resident means " the amount by which his exempt income derived from sources in Australia exceeds the sum of the expenses (not being expenses of a capital nature) incurred in deriving that income." In the case of the appellant company there was no " net exempt income " in the year 1941.

It was argued for the respondent that the provision in s. 80 (1) with respect to the allowable deductions exceeding the sum of the assessable income and the net exempt income of the year can apply only where there are both assessable income and net exempt income. In my opinion there is no substance in this contention. If there is no net exempt income the result merely is that the sum of the assessable income and the net exempt income (i.e. nil) is the amount of the assessable income. Accordingly, in my opinion, the application of s. 80 (1) is not excluded by the fact that the company had no net

H. C. OF A. 1946.

AMERICAN THREAD CO. v. FEDERAL COMMISSIONER OF TAXATION.

Latham C.J.

exempt income in the year in which it is claimed that a loss was incurred.

The first contention of the company is that the provisions of Subdivision *C* are as applicable for the purpose of ascertaining a loss as for the purpose of ascertaining a profit, and that as the application of these provisions in respect of the year 1941 showed a loss, that loss is an allowable deduction under s. 80. The difficulty in the way of this contention is said by the Commissioner to be that the effect of s. 43 (2) is to prohibit the allowance as a deduction of any amount taken into account in making up an account under Subdivision *C*, and also of any expenditure incurred directly or indirectly in relation to sales of goods in Australia to which the subdivision applies. The loss in 1941 is the result of taking into account amounts such as cost of goods in Scotland, cost of transport to Australia, and sundry expenses in Australia the allowance of which as deductions is prohibited by s. 43. Therefore there are in the case of this company no " allowable deductions from the assessable income " of 1941 which can be used for the purpose of ascertaining a loss under s. 80 (1).

Alternatively, the company contends that Subdivision *C* is not applicable because it is directed only to ascertaining profit, and not to ascertaining loss, and that therefore the company is entitled under s. 80 to deduct any loss incurred in 1941 which it can establish by applying the ordinary provisions of the Act independently of Subdivision *C*.

Section 43 (1) provides that the assessable income of a taxpayer shall include any profit as ascertained under the subdivision and s. 43 (2) provides that no amount taken into account in ascertaining any such profit, and no expenditure incurred directly or indirectly in or in relation to any such sale (that is a sale to which the subdivision applies—see s. 43 (1)) shall be an allowable deduction. " Assessable income " in this section is not used in the sense in which it is ordinarily used in the Act. " Assessable income " is defined in s. 6 as meaning all the amounts which under the provisions of the Act are included in the assessable income, and " taxable income " is defined as meaning the amount remaining after deducting from the assessable income all allowable deductions. Section 48 provides that in calculating the taxable income of a taxpayer the total assessable income derived by him during the year of income shall be taken as a basis, and from it there shall be deducted all allowable deductions. Thus ordinarily " assessable income " is a gross amount from which allowable deductions are made. Under Subdivision *C*, however, the profit which is declared to be included in " assessable income " is an amount which is calculated as the result of making the deductions

specified in s. 38 (or s. 39 which deals with the case of a merchant who imports goods and sells them in Australia). Thus that which is declared to be assessable income under s. 43 is a net amount and not a gross amount. It has been calculated by making the deductions permitted under preceding sections and s. 43 prevents any further deduction of amounts already so taken into account, and also of any expenditure in relation to the sales the profit from which has been ascertained by making only the deductions which are permitted by those preceding sections. Section 43 does not prohibit other deductions, for example, those which may be made under s. 78 (certain gifts and other payments) which have no relation to the ascertainment of profit on the sale of goods in Australia or to expenditure incurred in or in relation to any such sale.

The contention of the Commissioner is that s. 43 brings about the result, not only that a profit ascertained under Subdivision *C* is included in assessable income, but also by virtue of sub-s. (2) that the amounts and expenses referred to in that sub-section are not allowable deductions for any of the purposes of the Act. If this view be right then there was, in the case of this company, no loss in 1941, because the outgoings upon which the company relies for the purpose of showing that there was a loss in that year are prohibited as deductions under s. 43 (2), and therefore there is not an excess of allowable deductions over the assessable income (plus net exempt income, if any—but there was none in fact) of that year.

The solution of the difficulty is to be found, in my opinion, in recognizing that s. 43 applies only when a profit has been ascertained by the application of the provisions of Subdivision *C*. The subdivision begins by enacting in ss. 38 and 39 that a profit ascertained in the manner therein stated is deemed to be derived in Australia. Both of these sections relate to the sale of goods in Australia. Section 43 (1) then provides, in its first part, that the assessable income of a taxpayer shall include any profit derived by him in the year of income which under the provisions of the subdivision is derived or deemed to be derived in Australia. Where this provision applies it takes effect by bringing about the inclusion in " assessable income " of the profit ascertained under the subdivision. Where no such profit is so ascertained it is clear that this part of the section has no operation. The second part of s. 43 (1) provides that " the proceeds of any sale to which this subdivision applies " shall not otherwise be included in the assessable income. The sales to which the subdivision applies are certain sales of goods in Australia in cases where the application of the subdivision results in the ascertainment of a profit. If the application of the subdivision does not result in the

H. C. OF A. 1946.

AMERICAN THREAD CO. v. FEDERAL COMMISSIONER OF TAXATION.

Latham C.J.

ascertainment of a profit arising from any sales, then those sales are not sales to which the subdivision applies. If, therefore, the subdivision is not applied to any particular sales, the result is that the proceeds of those sales are not excluded from the assessable income of the taxpayer by reason of the latter part of s. 43 (1).

Section 43 (2) is also limited to cases in which the application of the provisions of Subdivision *C* results in ascertaining a profit. This is quite clear in relation to the first part of sub-s. (2)—" No amount taken into account in ascertaining any such profit . . . shall be an allowable deduction." The prohibition of the deduction of any such amount applies only where such amount has been taken into account in ascertaining " any such profit " ; that is, where the result of the application of the subdivision is that a profit is ascertained. If the result of the application of those provisions is that there is no profit, but a loss, then it cannot be said that the amounts which would have been taken into account under (in this case) s. 38, in ascertaining a profit if there had been a profit are amounts the deduction of which is prohibited under s. 43 (2).

Similar considerations apply to the second part of sub-s. (2) of s. 43—" no expenditure incurred directly or indirectly in or in relation to any such sale shall be an allowable deduction." This provision is limited to expenditure incurred in relation to " any such sale." The words " any such sale " refer back to the words in s. 43 (1)—" any sale to which this subdivision applies." For reasons already stated such a sale is a sale in respect of which the subdivision has been applied so as to result in ascertaining a profit which is deemed to be derived in Australia under preceding sections.

Accordingly, in my opinion, Subdivision *C*, including s. 43, applies only where the result of applying it is to show that there is a profit in the relevant year. If the application of the provisions of the subdivision shows that no profit ascertained in accordance with those provisions was made, then s. 43 is not relevant for any of the purposes of the Act.

In 1941 the application of Subdivision *C* did not show any profit, and therefore that subdivision should not be considered for any purpose in relation to that year. The endeavour to apply it has demonstrated that it is not applicable for the only purpose for which it can be used. Thus the company is in the position that it can claim a deduction under s. 80 if it can show that the conditions of s. 80 have been satisfied. In order to show that this is the case the company must establish that allowable deductions from the assessable income of 1941 exceeded the amount of that income. In order to ascertain whether this is the case, Subdivision *C* being inapplic-

able as irrelevant, the ordinary provisions of the Act must be applied; for example, s. 25 (1), which includes in the assessable income of a non-resident the gross income from all sources in Australia which is not exempt income, and s. 51, which provides that all losses and outgoings to the extent to which they are incurred in gaining or producing the assessable income, or are necessarily incurred in the carrying on of a business for the purpose of gaining or producing such income, shall be allowable deductions, with certain exceptions which are immaterial for the purposes of this case. In ascertaining the amount of such a loss, as the company carried on business both in Scotland and in Australia, it will be necessary to make some apportionment of receipts and expenses in order to ascertain the gross income derived from sources in Australia and the deductions from that income which are allowable. It may be, as pointed out on behalf of the Commissioner, that the resulting figure of loss will be different from the amount which has been ascertained by the endeavour to apply the plan of Subdivision *C* to the dealings of the year 1941. This may result from the fact that the deductions permitted by Subdivision *C* do not include certain deductions which might be allowed in cases outside the subdivision; for example, any allowance for depreciation, which (it might be claimed) should be allowed in determining the amount of a loss in order to apply s. 51 of the Act. On the other hand, it may be that the provisions of Subdivision *C* in the circumstances of this case provide a reasonable means of ascertaining the actual relevant loss, and in that case the result would be the same as if it had been provided that Subdivision *C* should be applied for the purpose of ascertaining loss as well as profit in cases where businesses are carried on partly in Australia and partly out of Australia. But the determination of the method according to which the loss should be ascertained in this case upon the basis that Subdivision *C* is not applicable to the case as a matter of statutory enactment is not before the Court in this case.

Accordingly, in my opinion, the question submitted in the case stated should be answered by declaring that the taxpayer is entitled to a deduction of the whole amount of £A2,392.

STARKE J. Case stated pursuant to the *Income Tax Assessment Act* 1936-1943 and the *Judiciary Act* 1903-1946.

The question stated is whether the appellant, the taxpayer, is entitled to a deduction from its income for its accounting period which ended on 31st December 1942 of the sum of (Australian) £2,392, or any part thereof as a loss pursuant to s. 80 of the *Income Tax Assessment Act* 1936-1943.

H. C. OF A. 1946.

AMERICAN THREAD CO. v. FEDERAL COMMISSIONER OF TAXATION.

Starke J.

It is stated that the taxpayer is a company incorporated in Scotland and there carrying on the business of manufacturing thread which it imports into and sells in Australia. Substantially it derives no income directly or indirectly from Australian sources other than that derived from its imports and sales already mentioned.

The taxpayer is not a resident of Australia.

The Commissioner assessed the taxpayer to income tax for the financial year 1943-1944 based on income derived during the year ended 31st December 1942 pursuant to the provisions of the *Income Tax Assessment Act* 1936-1943, Part III., Division 2, Subdivision *C* —" Business carried on partly in and partly out of Australia." He appears to have assessed the taxpayer pursuant to s. 40 rather than s. 38 or s. 39. The taxpayer disclosed an assessable profit from its Australian business for its accounting period which ended on 31st December 1942 of £1,906 sterling, (Australian) £2,392, but it claimed to deduct a loss of £1,906 sterling, (Australian) £2,392, which it had incurred in its Australian business in its accounting period which ended on 31st December 1941. The Commissioner disallowed this claim and assessed the taxpayer to income tax for the sum of (Australian) £2,392.

But for the provisions of Subdivision *C* the taxpayer would be entitled to the deduction claimed pursuant to the provisions of s. 80 of the Act.

Now Subdivision *C* provides a special method of ascertaining assessable income in the case of taxpayers carrying on businesses partly in and partly out of Australia. And s. 43 (1) enacts that:

"(1) The assessable income of a taxpayer shall include any profit derived by him in the year of income which, under the provisions of the subdivision, is derived or deemed to be derived in Australia and the proceeds of any sale to which this subdivision applies shall not otherwise be included in his assessable income.

(2) No amount taken into account in ascertaining any such profit, and no expenditure incurred directly or indirectly in or in relation to any such sale" (that is a sale to which the subdivision applies) "shall be an allowable deduction."

The profit derived by the taxpayer in the year of income 1942 ascertained pursuant to Subdivision *C* was, as already stated, (Australian) £2,392. And s. 43 (2) enacts that no amount taken into account in ascertaining that profit is an allowable deduction. The deduction claimed by the taxpayer was not taken into account in ascertaining any such profit and so far the sub-section is inapplicable. But the sub-section also enacts that no expenditure incurred directly

or indirectly in or in relation to any such sale shall be an allowable deduction.

Deductions allowed under ss. 38 and 39 include expenses incurred in transporting goods to and selling them in Australia in the accounting period though I apprehend that expenses of the character mentioned commonly treated as belonging to the accounting period though not actually expended in the accounting period would be rightly deducted (cf. *Amalgamated Zinc (De Bavay's) Ltd.* v. *Federal Commissioner of Taxation* (1)). So, therefore, the expenditure dealt with in s. 43 (2) refers to other expenses incurred, I apprehend, in the accounting period directly or indirectly in or in relation to the sales of any such goods. The object of the section is to disallow as deductions amounts taken into account in ascertaining profit in the accounting period for the purpose of Subdivision *C* and expenditure incurred directly or indirectly in that period in or in relation to sales to which the subdivision applies.

But the deduction claimed in the present case has not been brought to account in ascertaining the profit derived by the taxpayer in the accounting period, the year of income 1942, pursuant to Subdivision *C* nor does any part of it represent expenditure incurred directly or indirectly in that period in or in relation to the sale of goods to which the subdivision applies. It is a loss incurred in respect of sales to which Subdivision *C* applied in the accounting period 1941 and has no relation directly or indirectly to any sales to which the subdivision applies for the accounting period 1942.

In my opinion, therefore, there is nothing in this case to exclude the operation of s. 80 of the *Income Tax Assessment Act*.

The answer to the question stated should be in the affirmative as to the whole sum of (Australian) £2,392.

Dixon J. This case stated raises the question whether a loss sustained by a taxpayer in a business of selling in Australia goods which he has manufactured or bought abroad can be deducted by him, pursuant to the provisions of s. 80 of the *Income Tax Assessment Act*, in his assessment for a subsequent year.

Sub-section (1) of s. 80 provides that for the purposes of the section a loss shall be deemed to be incurred in any year when the allowable deductions from the assessable income of that year exceed the sum of that income and the net exempt income (an expression defined) and the amount of the loss shall be deemed to be the amount of such excess. The remaining sub-sections proceed to lay down the

(1) (1935) 54 C.L.R. 295, at p. 309.

H. C. OF A. 1946.

AMERICAN THREAD CO. v. FEDERAL COMMISSIONER OF TAXATION.

Dixon J.

conditions in which a loss is deductible and how the amount to be deducted is fixed and for that purpose define " net exempt income." But it is not upon these provisions that the difficulty arises and it is needless to state their effect. Sub-section (1), however, appears to me to be an exhaustive statement of the kind of loss to which they refer and it contains an expression which does contribute to the difficulty. It is the expression " allowable deductions." Section 6, rather unnecessarily, defines " allowable deduction " to mean a deduction allowable under the Act. Division 3 of Part III. is headed " deductions " and contains a number of directions, both general and particular, authorizing the allowance of deductions. As they apply to a selling business the general result is to enable the taxpayer to deduct from his assessable income his expenses and outgoings as a trader, including, of course, such items as purchases, freight, insurance, selling expenses and bad debts.

If no more appeared, therefore, a taxpayer selling goods in Australia which he obtained by manufacture or purchase abroad could, if his transactions for an accounting period resulted in a loss, claim that he had incurred a loss of the nature described by sub-s. (1) of s. 80. But more does appear. Subdivision *C* of Division 2 of Part III., containing ss. 38 to 43, is headed " Business Carried on Partly in and Partly out of Australia " and includes specific directions for the ascertainment of the profit derived from the sale of goods in Australia by a manufacturer abroad or an importer. The profit ascertained according to the directions is to be carried into the assessable income of the taxpayer. It is an exceptional way for the Act to treat profit. For the plan adopted by the legislation for ascertaining taxable income is to aggregate all gross revenue on one side under the description of assessable income and all outgoings and allowances on the other side under the description of deductions. To isolate, as Subdivision *C* does, the proceeds of a certain kind of transaction, to direct the computation specially of the net profit therefrom and to provide that the net profit, when so found, is to be taken in as an item of assessable income is to proceed according to a different conception foreign to the general plan. To fit it into the plan at all, it is apparent that some provision is necessary against a double use of items of revenue or of expenditure. Items which are taken into account in ascertaining the profit of the isolated transactions cannot be permitted to appear again and to enter the aggregate of assessable income or of deductions as, in the absence of some express provision to the contrary, they must under the general plan of the enactment. To meet this difficulty a special provision is

included in Subdivision *C*. It is sub-s. (2) of s. 43 and it is expressed as follows :—" No amount taken into account in ascertaining any such profit, and no expenditure incurred directly or indirectly in or in relation to any such sale, shall be an allowable deduction." The expression " such sale " refers back to an antecedent in sub-s. (1), namely " any sale to which this subdivision applies." It is sub-s. (2) that combines with the expression quoted from s. 80 " allowable deduction " to complete the legislative direction forming the source of the difficulty which confronts a trader in goods he brings from abroad when he claims to deduct a loss sustained in a prior year. For obviously the loss of the prior year must consist in a large measure of the excess expenditure incurred in relation to sales to which Subdivision *C* applies. Yet sub-s. (2) of s. 43 says that no such expenditure shall be an allowable deduction and sub-s. (1) of s. 80 says that the loss must consist of the excess of allowable deductions over revenue.

Thus a text is made from the two provisions which upon the surface appears to be a complete enough statement upon which to exclude any deduction of a prior loss sustained in a business of making sales of the kind to which Subdivision *C* applies. The result is a strange one and it is hard to imagine any policy that it might reflect. If such a trader is excluded from the general provisions authorizing the deduction of losses of specified prior years, it would seem to be the fortuitous consequence of bringing into juxtaposition two directions each penned *alio intuitu*.

But a closer examination of Subdivision *C* discloses what in my opinion are cogent reasons for concluding that what I have called the surface appearance of the provision does not accord with either the true interpretation of the whole subdivision or the exact meaning of the precise expressions on which the exclusion of prior losses depends. The evident purpose of Subdivision *C* is to provide some ready means of solving the otherwise intractable problem of attributing to a territorial source the whole or portion of a profit realized in this country at the termination of a connected series of business operations beginning abroad with the production or purchase of vendible commodities. It is for that reason that it departs from the plan otherwise pursued by the Assessment Act of computing separately gross revenue and gross outgoings or other deductions and enters at once upon the ascertainment of the net gain from distinct transactions. It is for the same reason that it confines itself to profit and does not concern itself with transactions resulting in loss. Its task is territorial attribution, allocation or apportion-

H. C. OF A. 1946.

AMERICAN THREAD CO. v. FEDERAL COMMISSIONER OF TAXATION.

Dixon J.

ment, and the only subject of that task is profit. The direction contained in sub-s. (2) of s. 43, the concluding provision of the subdivision, is consequential and arises out of the necessity which ensues only from the taking of such a profit into the general assessable income.

It is necessary to throw out of the computation of assessable income items of expenditure only when they belong to the ascertainment of the actual profit which in fact is independently taken into assessable income under the direction contained in sub-s. (1) of s. 43. It is true that the exclusion required by sub-s. (2) is not limited to the amounts actually taken into account in ascertaining the profit but extends to expenditure incurred directly or indirectly in or in relation to sales to which the subdivision applies. But that is only because both s. 38 and s. 39 are rigid in confining the deductions allowed from the selling price to the value of the goods in the country of manufacture or their purchase price, as the case might be, together with the expenses of transporting them to and selling them in Australia. Other expenses which belong to the transaction ending in the marketing of the goods here must not be included, and consequentially must be excluded, too, from the assessable income lest they are let in under the general provision and the principle of limiting the deductible expenses under ss. 38 and 39 is thereby indirectly defeated.

It is therefore evident that s. 43 (2) was introduced with but one purpose, namely, as consequential upon the ascertainment, under the earlier provisions of the subdivision, of the profit of sales within its ambit and upon the inclusion of the profit in the assessable income. As this is its function there are strong *a priori* grounds for treating the sub-section as applicable only in cases where there is a profit. As soon as it is found that there is no profit the subdivision has no application; there is no subject matter upon which it can operate to produce any effect. In this view it would be remarkable if the final sub-section nevertheless had a further operation, one foreign to the purpose of the anterior provisions, and worked a general denial of the character of an allowable deduction for any purpose to all forms of expenditure in relation to sales of goods brought in from abroad for sale here by a manufacturer or purchaser.

From these general considerations it is now necessary to turn to the precise language of the provision and examine it. The critical words are " any such sale " and these words, as already stated, refer back to and are equivalent to " any sale to which this subdivision applies." This expression is not the same as " any sale of the foregoing description." The word " applies " means " operates upon " and the whole

expression refers to the legal application and operation of the provisions of the subdivision. It predicates of the case to which it refers that it has undergone the operation of those provisions so that the result has been produced which they are designed to effect. That occurs only when there is profit. Resort to the provisions for the purpose of ascertaining whether there is a profit or not is only an examination of the facts in relation to the criteria they supply to discover whether the case, that is the sale, is one to which they do apply. When there is no profit the subdivision does not apply to the sale.

The precise meaning of the material words contained in s. 43 (1) and (2) therefore accords with the general scope and purpose of the subdivision and shows that the surface appearance produced by bringing together the words " allowable deductions " from s. 80 (1) and the last phrase in s. 43 (2) is fallacious.

I am, therefore, of opinion that Subdivision *C* does not exclude from the general provisions contained in s. 80 losses incurred in a prior year by a trader who, if he had made profits in that year, would have been liable to have them ascertained under that subdivision.

So far I have dealt with the question in abstract form. The facts disclosed by the case stated before us call for no special discussion. But curiously enough in the ascertainment of the profit of the accounting period under assessment for the financial year of tax, the directions of s. 38 were not followed precisely. An account was used in which stock on hand at the beginning and end of the period and purchases and sales during the period were compared. Commonsense and convenience, though not the exact terms of s. 38 or s. 39, justify the process, which doubtless will suffice, when both the Commissioner and the taxpayer are content to use it. The loss of the prior year, which happens to be the preceding year, was ascertained by the same form of account which of course is more of the kind needed for the application of s. 80 (1) in combination with, for example, s. 51.

For the year under assessment the taxable income ascertained in the manner mentioned, but in disregard of the claim to deduct the prior loss, amounts to £2,392 (Australian) and for the preceding year the loss amounted to a considerably greater sum. We need not be concerned with the calculation of the loss, about which no question was raised. The question in the case stated asks in substance whether the prior loss up to the amount of the income of the year under assessment is deductible.

For the reasons given, my opinion is that the question should be answered: Yes, the whole.

H. C. OF A. 1946

AMERICAN THREAD CO v FEDERAL COMMISSIONER OF TAXATION

McTIERNAN J. I have had the advantage of reading the judgments and reasons of his Honour the Chief Justice and my brother Dixon and concur in them and have nothing to add.

Question in case answered: Yes, of the whole sum of £(Australian)2,392. Case remitted to Rich J. Costs of case to be costs in the appeal.

Solicitors for the appellant, *Malleson, Stewart & Co.*

Solicitor for the respondent, *G. A. Watson*, Acting Crown Solicitor for the Commonwealth.

E. F. H.