Appl FCT v Marshall & Brougham Pty Ltd 73 ALR 261
Discd FCT v La Rosa (2003) 198 ALR 521
Dist FCT v La Rosa (2003) 53 ATR 1
Dist FCT v La Rosa (2003) 129 FCR 494

[HIGH COURT OF AUSTRALIA.]

GUINEA AIRWAYS LIMITED . . . APPELLANT;

AND

FEDERAL COMMISSIONER OF TAXATION RESPONDENT.

H. C. OF A. 1949. ADELAIDE, *Sept.* 27. MELBOURNE, *Dec.* 22. Dixon J. 1950. ADELAIDE, *Sept.* 29, *Oct.* 2. SYDNEY, *Nov.* 13. Latham C.J. McTiernan, Webb, Fullagar and Kitto JJ.

Income Tax (Cth.)—Assessment—Deductions—Losses and outgoings (not being of a capital nature) incurred in gaining or producing assessable income or necessarily incurred in carrying on business for purpose of gaining or producing such income—Loss of stocks of spare parts and stores for use in business—Capital or income—Depreciation—Loss of depreciated property—Income Tax Assessment Act 1936-1942 (*No.* 27 *of* 1936—*No.* 50 *of* 1942), *ss.* 51 (1), 54, 59.

G. Ltd. was an air transport company operating in New Guinea. In order to carry on its business it maintained there large stocks of general stores and of spare parts for the maintenance and repair of its aeroplanes. These stocks were destroyed when Japan invaded New Guinea. In its return for the relevant year of income the company claimed to be entitled to deduct as a loss, under s. 51 (1) of the *Income Tax Assessment Act* 1936-1942, the difference between the cost price of the goods destroyed and the amount awarded under the *National Security* (*War Damage to Property*) *Regulations* as compensation for their loss.

Held, that the loss was a loss of a capital nature and therefore was not deductible under s. 51 (1).

Held, further, that the loss could not be treated as depreciation under ss. 54 and 59 of the Act.

Decision of *Dixon* J. affirmed.

APPEAL from *Dixon* J.

An objection was lodged by Guinea Airways Ltd. to the assessment of it to income tax for the year of income ending 30th June 1943, based on income derived during the company's accounting period of twelve months ending 28th February 1942.

The Commissioner of Taxation disallowed the objection and the company appealed to the High Court.

The relevant facts are fully set out in the judgment of *Dixon* J. hereunder.

E. Phillips K.C. and *J. J. Redman*, for the appellant.

J. W. Nelligan K.C. and *C. A. Sandery*, for the respondent.

Cur. adv. vult.

DIXON J. delivered the following written judgment:—

This is an appeal from an assessment to income tax for the financial year ending 30th June 1943 based on income derived during an accounting period of twelve months ending 28th February 1942. The appellant, an incorporated trading company, carried on the business of transporting passengers and goods by air in Papua and New Guinea. The base for its air services was Lae in New Guinea. There it had hangars workshops stores and other buildings. On 21st January 1942 the Japanese Air Force bombed Lae and the company's building stores and equipment were destroyed. Among the property destroyed were large quantities of spare parts for the airframes and engines of the company's aeroplanes. In accordance with the common practice of air transport services the company maintained a large stock of spare parts. The spare parts were stored in bins whence they were drawn as occasion required. In addition to the stock of spare parts for aeroplanes the company also carried at Lae a store of equipment and other things needed for the maintenance of the depot. This too was destroyed. In respect of its various losses as a result of the bombing at Lae the company claimed compensation under the *National Security* (*War Damage to Property*) *Regulations*. In pursuance of reg. 38 the War Damage Commission assessed the amount of the loss and recorded it. At that time under reg. 38 (3) the amount of compensation assessed and recorded was to be tentative only and did not become payable until the end of hostilities, when it might be reviewed. The law was afterwards changed by S.R. No. 4 of 1945. The amount at which the War Damage Commission recorded the loss in respect of spares for aircraft was £19,570 and the loss in respect of general stores £7,510. The aircraft stores stood in the books of the company at a figure which may be taken to be £25,361 and the general stores at £7,702. The difference is in the one case £5,791 and in the other £192, making in all £5,983. This difference the company claims to deduct from its assessable income in arriving at the taxable income of the accounting period. The accounts in

H. C. OF A. 1949-1950.

GUINEA AIRWAYS LTD. v. FEDERAL COMMISSIONER OF TAXATION.

Dixon J.

which stood the respective figures of £25,361 for aircraft stores and of £7,702 for general stores consisted in the one case of an assets account known as the Aircraft Spares Account and in the other of an analogous account called the General Stores Account. When aircraft spares were purchased and taken into store at Lae the Aircraft Spares Account was debited with the cost into store consisting of the prime cost together with freight insurance duty and other charges. When spare parts were drawn and issued from the store for use, an amount was charged against running costs consisting of the cost into store of the spare parts so issued with ten per cent added. The corresponding credit of the amount so charged was divided into two. The added ten per cent was credited to an account called the Reserve for Depreciation Aircraft Spares New Guinea Account. The cost into store was credited to the assets account called the Aircraft Spares Account. The result would be that the debit balance of this latter account should show the cost into store of the aircraft spares which had been taken into the bins and had not been issued. The same system of accounting was applied to the General Stores Account. In the balance sheet of the company apparently it was the practice to show the total of the debit balances of the two accounts on the assets side under "Inventory: Spare Parts: Stores etc. less Depreciation". But at what figure does not appear, since the balance sheet in evidence is compiled as at 28th February 1942 after the bombing and shows the war damage claim as an asset. It was not explained why the War Damage Commission recorded the amount of compensation at £5,983 less than the book value of the spare parts and stores but there is something to suggest that the amount disallowed represents articles that had been in stock so long as to be obsolete or to have depreciated, possibly through deterioration.

The sum of £5,983 which the company claims to deduct from its assessable income may thus represent a loss in value that had in fact accrued, but had not been ascertained, before the bombing. It may however represent part of the existing value of what was destroyed by the bombing, a part that the company has failed to recover from the War Damage Commission.

In either view the company claims that the loss is deductible under s. 51 of the *Income Tax Assessment Act* 1936-1942. In my opinion this contention of the company must fail on the ground that the loss was a loss of capital or of a capital nature.

The company had formed or built up a reservoir of spares for aircraft and of stores of considerable size and value and maintained it as part of its permanent establishment. It does not appear

whether it had been built up gradually or formed initially, but it is immaterial which way it was done. To maintain an available stock of spares and stores at a proper level the requisite amount of capital must be committed to the purpose. The ingredients in the stocks might change. Spares would be drawn and new spares taken into store in the ordinary course of business. But the stock of spares remained. The existence of the stock of spares was a feature of the permanent organization of the enterprise. It formed part of the general equipment. When spare parts were issued and taken into use, it was right no doubt to debit the cost to running expenses, though whether for purposes of income tax the ten per cent could be added is another matter. But it by no means follows that the spare parts constituting the reservoir represented anything but capital. Moreover the stocks did not represent circulating capital. Money was not laid out in the purchase of spare parts and then recovered, together with a profit, on their resale. Stock in trade, because of its nature and function, is valued at the beginning and end of an accounting period and if any part of it is lost or destroyed in the interval the loss is reflected in the comparison of the two values. But the permanent stock of spare parts and stores forms part of the profit yielding subject, as Lord *Blackburn* called it in *United Collieries* v. *I. R. C.* (1); cf. *Sun Newspapers Ltd.* v. *Federal Commissioner of Taxation* (2). In *Abbott* v. *Albion Greyhounds Ltd.* (3) it was agreed that the cost of buying greyhounds for the purpose of filling gaps in the kennels of a dog racing company was a deductible expense, but a distinction was drawn between that and raising or increasing the establishment, which, as I read it, *Wrottesley* J. considered would involve a capital expenditure, as the Crown said. The racing life of a dog is less than two years. But the dogs were not the company's stock in trade to be valued. That case provides an illustration of the principle.

The stores and the spare parts have not gone into use or consumption. The sums of £7,702 and £25,361 which the company said was their value was money locked up in the bins and the stores with the stocks of spares and other things they always contained. The reservoir of spare parts and stores is from a business point of view an entity existing independently of the changing identity of the elements forming it. The loss that the company has suffered simply represents part of the value of the entity. There has never

(1) (1929) 12 T.C. 1248, at p. 1254.
(2) (1938) 61 C.L.R. 337, at pp. 359-363.
(3) (1945) 1 All E.R. 308.

H. C. OF A. 1949-1950.

GUINEA AIRWAYS LTD. v. FEDERAL COMMISSIONER OF TAXATION.

Dixon J.

been any attempt in the company's accounts to treat the expenditure incurred in establishing it, or in building it up, as a revenue expenditure. No debit was made to revenue account until a spare part was issued and went into use. No part of the £25,361 or the £7,702 is or has been reflected in profit and loss. For these reasons I think that the loss is one of capital or at all events is of a capital nature and cannot be deducted under s. 51.

The commissioner relied upon further answers to the company's use of s. 51 in support of its claim to the deduction. But, as I accept the commissioner's view that the loss is an affair of capital, it is unnecessary to discuss them.

On behalf of the company, however, some reliance was placed on s. 59. Section 59 could not apply unless the spares or the stores, as the case may be, were brought within s. 54. Even if they could be treated as " plant " within that provision, which I doubt, I do not think that it could be said that that thay had been used during the year for the purpose of producing assessable income or had been installed ready for use for that purpose. These, or one of them, form essential conditions of the application of s. 54.

In my opinion the claim to deduct the loss fails. The appeal will be dismissed with costs.

From this decision Guinea Airways Ltd. appealed to the Full Court.

K. L. Ward K.C. (with him *J. J. Redman*), for the appellant.

J. W. Nelligan K.C. (with him *C. A. Sandery*), for the respondent.

Cur. adv. vult.

Nov. 13.

The following written judgments were delivered :—

LATHAM C.J. This is an appeal from an order of *Dixon* J. dismissing an appeal from an assessment of Guinea Airways Limited to income tax. The question which arises relates to a deduction claimed by the company under s. 51 (1) of the *Income Tax Assessment Act* 1936-1942. Section 51 (1) is in the following terms :—

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

The taxpayer is an air transport company operating in New Guinea. It necessarily maintained a stock of spare parts for the maintenance and repair of its aeroplanes and a stock of general stores which were required in order to carry on its business. The remoteness of the territory in which it operated necessitated the carrying of substantial stocks. When Japan invaded New Guinea the physical assets of the company were destroyed. A claim was made under the *National Security* (*War Damage to Property*) *Regulations*, but the full amount claimed was not awarded. The result is that the company claims that there was a loss in respect of the spare parts and stores of an amount which was finally stated at £5,983. It was not disputed that this loss had been suffered, but it was contended for the commissioner that the loss was a loss of a capital nature and so was not deductible under s. 51 (1).

The value of the spare parts destroyed was stated by the company to be £25,361 and of the general stores £7,702. In the objection to the assessment lodged by the company it was claimed that the general stores were stores held not only for the use of the company, but also for sale to other airline operators, and if this had been the case it would have been necessary to consider how far the general stores represented stock in trade acquired and held for purposes of resale. There was, however, no evidence of this suggested fact and I read the accounts of the company for the relevant year as showing that the stores, so far as they were used, were used for the purposes of the company itself.

The claim of the company is not a claim for deduction of the amount expended in purchasing the spare parts and stores or of the value of those actually used. It is a claim in respect of their loss. When spare parts and consumable stores were used for the purpose of maintaining and repairing (as distinct from renewing or replacing) the aircraft and other material assets which constituted the plant of the company a deduction could properly be claimed for purposes of assessment to income tax because the utilisation in the manner stated of such spare parts or general stores would constitute part of the working expenses of the year in which they were so used. The statement of facts agreed between the parties includes a statement that during the relevant accounting period aircraft spare parts costing £4,212 were taken into account and during that period issues (for actual use) of aircraft spare parts out of stores on hand totalled £2,525. The balance shown in the account of the company as remaining at 21st January 1942, when the Japanese aircraft bombed Lae, was £25,361. There is a corresponding statement with respect to stores. The claim of the

H. C. OF A. 1949-1950. GUINEA AIRWAYS LTD. v. FEDERAL COMMISSIONER OF TAXATION. Latham C.J.

company relates, therefore, to a large quantity of spare parts and stores which were not in fact used in the maintenance and repair of the company's plant, but which were intended to be so used. In its statement of objection to the assessment the company stated:—"The assets comprising the items of objection were assets used for the repair, maintenance and reconditioning of our aircraft as distinct from fixed plant." It is, however, clear that the assets in question had not in fact been so used. What was destroyed was a large stock of assets, much greater than, according to the facts before the court, any annual quantity which was intended to be used in the maintenance and repair of the aircraft of the company.

The provision of these stocks of goods does not represent incidents in the carrying on of the enterprise of the company from day to day whereby it earned its income. As I have already said, so far as the spare parts &c. were actually used in repairing &c. aeroplanes, their cost would be deductible. But the cost of maintaining a large stock which, though it probably represents a wise policy, is beyond any requirements for prospectively immediate use cannot, in my opinion, be regarded as an expenditure properly chargeable to income account. It represents, in my opinion, an expenditure of the capital of the company in procuring an asset to be used in the future in carrying on the income-earning enterprise of the company. Accordingly I agree with *Dixon* J. that the claim for the deductions was properly disallowed by the commissioner.

It was alternatively argued for the appellant that under ss. 59 and 54 of the Act a deduction should have been allowed. Depreciation, it was claimed, was allowable in respect of the property of the taxpayer which was destroyed (s. 59) and it was urged that the articles which were destroyed were articles owned by the taxpayer which had been installed ready for use for the purpose of reducing assessable income (s. 54). But, in my opinion, it cannot be said that the articles in question were in any sense installed ready for use.

In my opinion the appeal should be dismissed.

McTiernan J. I agree that the appeal should be dismissed.

The case depends upon the question whether the facts establish that the stock of spares and stores which were destroyed was, on the one hand, an adjunct to the appellant's profit-earning equipment, or, on the other hand, that the maintenance of the store was incidental to its operation. The facts lead, in my opinion, to

the former conclusion. The result is that the loss was of a capital nature and the money expended in purchasing the spares and stores which were destroyed is not a loss or outgoing which s. 51 allows as a deduction.

The submission based upon ss. 54 and 59 fails because the facts do not warrant the conclusion that any of the spares or stores were installed ready for use.

WEBB J. I have had the advantage of reading the judgment of *Kitto* J. For the reasons given by his Honour I think the appeal should be dismissed.

FULLAGAR J. In this case I agree with the judgment of *Dixon* J., and I do not feel that there is anything that I can usefully add. In my opinion the appeal should be dismissed.

KITTO J. The appellant company carried on an air transport business and had a base at Lae. It established there a considerable stock of spare parts for its aircraft and of general stores, for it was common practice and essential for the efficient conduct of the business to have such goods available for immediate use when the occasion demanded. The bombing of Lae by the Japanese on 21st January 1942 resulted in the destruction of these stocks, which at that time stood in the company's books at the amount of their cost price. In respect of the loss thus incurred the company became entitled to receive compensation under the *National Security* (*War Damage to Property*) *Regulations*. The difference between the cost price of the goods destroyed and the compensation recoverable from the War Damage Commission was £5,791 in the case of the spare parts, and £192 in the case of the general stores. The aggregate of these sums, £5,983, the company claimed to be an allowable deduction in the assessment of its income tax in respect of income derived during the accounting period ending 28th February 1942. The claim was disallowed by the commissioner, and an appeal from the disallowance was dismissed by *Dixon* J.

The company's main contention was that the loss of £5,983 was an allowable deduction under s. 51 (1) of the *Income Tax Assessment Act* 1936-1942. The commissioner considered, and *Dixon* J. agreed, that the loss of £5,983 was a loss of capital, or of a capital nature, and was therefore excluded by the express terms of s. 51 (1) from the category of deductions which that sub-section makes allowable.

H. C. OF A. 1949-1950. GUINEA AIRWAYS LTD. v. FEDERAL COMMISSIONER OF TAXATION. Kitto J.

The losses to which s. 51 (1) applies are gross losses, not net losses; and if any deduction is allowable under that section in respect of the destruction of the spare parts and general stores it must be, I should think, a deduction of their cost price, and the war damage compensation should be included in assessable income. At least it is clear, I think, that unless the compensation is a receipt on revenue account, the loss consisting of the difference between the compensation and the cost price of the goods destroyed cannot be a loss of an income nature. It is useful, therefore, to consider whether the compensation is a revenue receipt. Now, although some goods comprised in the stock of general stores appear to have been sold on occasions, it is clear that the company was not engaged in trading in such goods. The case is in this respect the converse of *J. Gliksten & Son, Ltd.* v. *Green* (1), in which it was held by the House of Lords that moneys received by a company under a policy of insurance in respect of the destruction of timber by fire constituted a trading receipt. The reason was that the timber was trading stock which it was the company's business to turn into cash. As Lord *Hanworth* M.R. expressed it in the Court of Appeal (2):—"A sum has been received in respect of the timber. That amounts to a restoration to the circulating capital of a sum which had previously been invested in specie in timber." The contrary is the case where assets are destroyed which are not trading stock; the receipt of insurance moneys or compensation in respect of their destruction is not a restoration of circulating capital and, in my opinion, is not a receipt on revenue account. It seems to me to follow that the loss in respect of which the insurance moneys or compensation become receivable is a loss of a capital nature.

In this case it is clear that it was not circulating capital that was destroyed. If a new propeller blade had been affixed to one of the company's aircraft by way of replacement immediately before the Japanese attack, the destruction of the new blade together with the aircraft would clearly have meant a loss of a capital nature. The position cannot be different because the blade was destroyed while still among the company's stock of spare parts.

The truth appears to me to be that the spare parts and stores represented an investment of capital moneys. The goods had been acquired before they were actually needed, so that no time would be wasted in getting them when the need for them arose. In this sense they were held in reserve, just as money for the purchase of spare parts when needed might have been kept in a

(1) (1929) A.C. 381. (2) (1928) 2 K.B. 193, at p. 202.

bank or in a safe. If money so kept had been lost, e.g., by the failure of the bank or the destruction of the safe, the loss could not be regarded as other than a capital loss.

In argument it was suggested that the principle of *Commissioner of Taxation* v. *Commercial Banking Co. of Sydney Ltd.* (1) might be applied. In that case, as in *Punjab Co-operative Bank Ltd., Amritsar* v. *Commissioner of Income-Tax, Lahore* (2), the question considered was the nature of a profit made upon a change of investment of moneys held by a bank to be available as a " second line of defence " should the exigencies of its business make it necessary to resort to them, and it was held that the profit was of an income nature. There is a superficial resemblance but a fundamental difference between such a case and the present. In the case of a banker, money is his stock in trade, and any profit or loss he makes in dealing with money in the course of his business is on revenue account, notwithstanding that the money is in a sense held in reserve. In a case such as the present, however, money is not stock in trade, and neither are spare parts and stores bought with it ; and if either money or goods be lost while held as a fund or stock to meet future needs, the loss is a loss on capital account.

In my opinion the company's contention based upon s. 51 (1) was rightly rejected.

A second contention advanced by the company was that the loss was made an allowable deduction by s. 59. I agree with *Dixon* J. in thinking that it is a sufficient answer that s. 59 could not apply unless the spares or stores were, within the meaning of s. 54, used by the company during the relevant year for the purpose of producing assessable income or had been installed ready for use for that purpose, and that plainly they were not so used and cannot properly be described as having been installed.

Appeal dismissed with costs.

Solicitors for the appellant: *Finlayson, Phillips, Astley and Hayward.*

Solicitor for the respondent: *K. C. Waugh,* Crown Solicitor for the Commonwealth.

B. H.

(1) (1927) 27 S.R. (N.S.W.) 231 ; 44 W.N. 65.

(2) (1940) A.C. 1055.