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IN THE COURT OF APPEAL OF NEW ZEALAND

reported by CCH and NZTR

No case on Appeal (Not sent in by CA) 579

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C.A.20/77

BETWEEN DE PELICHET MC.LEOD AND COMPANY LIMITED of Hastings, merchants and stock and station agents

Appellant

AND COMMISSIONER OF INLAND REVENUE

Respondent

Coram: Richardson J.
McMullin J.
Somers J.

Hearing: 29 July 1981

Counsel: J. Prebble for appellant
P. J. H. Jenkin for respondent

Judgment: 30 July 1981

JUDGMENT OF THE COURT DELIVERED BY RICHARDSON J.

This is an appeal against a judgment of Ongley J. delivered as long ago as 29 October 1976 in which on a case stated under s.32 of the Land & Income Tax Act 1954 he upheld certain assessments of income and income tax for the four income years ended 31 March 1965 to 31 March 1968. What was in issue was the deductibility of rates, land tax and rents incurred in those years in respect of properties owned by the appellant at Horomatangi Street, Taupo, Mersey Street, Napier, and Omahu Road, Hastings. It was held that the deductions claimed did not meet the statutory test under s.111 of the 1954 Act. No other authority for the deduction having been relied on, the expenditures in questions were barred from deduction by s.110 which, as it read at the material times and except as expressly provided in the Act, prohibited the making

of any deduction in respect of any expenditure for the purpose of calculating the assessable income of any taxpayer.

The appellant, De Pelichet McLeod & Company Limited, is an old established company. Its head office is at Hastings. It carries on there and elsewhere the business of merchants and stock and station agents. The relevant circumstances relating to the acquisition, use and disposal of each of the three properties in question may be stated quite shortly.

Horomatangi Street, Taupo

In 1957 the directors had in mind extending business operations to Taupo by establishing a branch of the firm there. Three properties were acquired in 1958 for that purpose. The first was at Atiamuri Road, the intention at the time being to erect a bulk store on the site. The second was the lease of a shop in the main shopping area, the immediate intention being to establish grocery, hardware and farm hardware departments there. The third, a freehold quarter-acre section at Horomatangi Street, was purchased on 8 December 1958 for $11,000, the ultimate intention of the directors being to erect business premises for the company on that site. The shop was opened and from the outset the quarter-acre section, which was approximately 30 to 50 yards away from the shop, was used for customer parking. The business expanded, staff members were appointed on the stock and station side, a produce store was built on the Atiamuri Road site and later a temporary office was erected there.

About August 1964 the appellant closed the shop and concentrated its Taupo business at the Atiamuri Road site.

The quarter-acre section continued to be used as a parking lot by customers of the appellant and by staff members in the course of business. Eventually the appellant ceased operations in Taupo. It sold the Atiamuri Road site in September 1969 and nine months later it sold the quarter-acre section at Horomatangi Street. Thus as events transpired that site was used during the income years in question 1 April 1964 to 31 March 1968 for parking purposes only. The expenses in question were for rates and land tax, totalling some $2,000 over that four-year period.

Mersey Street, Napier

In June 1965 the appellant took up a lease of a 7-acre site in a new industrial area. At the time the company's intention was to concentrate all wool store operations there and to provide for expansion of those operations. For those purposes it intended to build a substantial wool store. Barley was sown in 1967 and harvested in January 1968 and the land was then put down in grass. From time to time the land was used to hold stock overnight between stock sales but it is not clear that it was used to any substantial extent for that purpose during the income years in question. Other wool store premises became available and there were other commercial changes which led the appellant to sell its leasehold interest in the land in 1971. The expenses incurred during the three income years 1966, 1967 and 1968 for rent and rates totalled $12,200. The proceeds of sale of the barley crop amounted to $294.06 and barely covered the direct costs involved.

Omahu Road, Hastings

On 31 January 1966 the appellant bought a freehold property of 3 acres 2 roods 26.1 perches for $40,000. It intended to re-establish there its seed store and seed dressing plant which were then housed at its head office premises, and to provide sufficient space for the development of grain silos to cater for a substantial increase in the production of grain which was taking place in the district. At the time of the purchase the land in question was the only free land available in the industrial area which was suitable for the appellant's purposes. The appellant intended to sub-divide and sell off the existing house property and other parts of the land keeping approximately 1 to 1½ acres for its own purposes. It surveyed the land for subdivision and put the parts of the land it did not wish to retain on the market. In the meantime the house was let at a rental of $2 per week and a neighbouring businessman also paid $2 per week (but it seems only from a date outside the years in question) for the use of part of the site for parking and storing agricultural machinery. From time to time the appellant also used part of the land to store posts and battens for its produce department. The appellant originally intended to build on the site "in the near immediate future". However, it decided to erect grain facilities at another branch first, and as events transpired and for good commercial reasons it eventually sold the whole property in 1974 or 1975 without having built on it.

The rates and land tax paid in respect of the property during the three income years ended 31 March 1968 amounted to something less than $1,600. The total rents received (which

it appears have been included in the assessable income) are not given in evidence but an offset of $40 in respect of rents derived has been allowed by the Commissioner in adding back the expenditures disallowed for the 1968 years.

The judgment in the High Court

It was not suggested in the High Court that the appellant purchased any of the properties with a view to profit-making on re-sale, and it was held that the purpose of the purchase in each case was to continue and expand the appellant's business. Ongley J. also accepted that the disposal of each property was dictated by changed circumstances except, of course, for the part of the Hastings land which being surplus to the appellant's requirements was always destined for re-sale. But while he was prepared to accept and did accept that all three purchases were made with the object of producing income in the future, he emphasized that in each case it was obviously contemplated by the appellant that there would be a lapse of time before the particular piece of land commenced to fulfil the function which the directors had in mind for it. It was that consideration that led him to conclude that while in each of the years under review the appellant expended the monies in question in producing the modest amount of income received from the properties, it did not expend those monies for that purpose alone. A further purpose of the expenditure was to ensure the retention of the capital asset in each case for its future development and consequent increased income earning capacity in future years, that latter purpose being in the Judge's view the major

purpose of the expenditure. In the result he held that the expenditure was incurred exclusively for the production of income but not that it was so incurred for the production of income in the year of assessment, and accordingly he found that it was not deductible under s.111. Although in the event it was not necessary for the Judge to do so, he went on to consider and rejected the alternative argument advanced for the Commissioner that the expenses were capital expenditures barred from deduction under s.112(a). His reasoning was that the essential character of rates, rent and land tax as revenue deductions expended in the production of income was not affected by the consideration that the income to the production of which they were directed was income to be derived over a period of years and that those items could not properly be regarded as part of the cost of the land or as bearing the characteristics of capital payments in any other respects.

The legal issues

Section 111 and s.112(a), as they stood at the material times, read as follows:

> "111.(1) In calculating the assessable income of any person deriving assessable income from one source only, any expenditure or loss exclusively incurred in the production of the assessable income for any income year may, except as otherwise provided in this Act, be deducted from the total income derived for that year.
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> (2) In calculating the assessable income of any person deriving assessable income from two or more sources, any expenditure or loss exclusively incurred in the production of assessable income for any income year may, except as otherwise provided in this Act, be deducted from the total income derived by the taxpayer for that year from all such sources as aforesaid.
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> 112. Notwithstanding anything to the contrary in section 111 of this Act, in calculating the assessable income derived by any person from any source, no deduc-

> tion shall, except as expressly provided in this Act, be made in respect of any of the following sums or matters:
>
> (a) Investment, expenditure, loss, or withdrawal of capital; money used or intended to be used as capital; ..."

Section 111 was recast in 1968 following the report of the Taxation Review Committee in October 1967. In paragraphs 473 to 477 of its Report the Committee described the then s.111 as an "anachronism"; pointed out what appeared to the Committee to be its major faults; noted that successive Commissioners of Inland Revenue had acknowledged those defects in the section and had applied a "liberal" interpretation; concluded that there were obvious disadvantages in relying on the Commissioner's practice; recommended that the section be amended along the general lines of s.51 of the Australian Income Tax Assessment Act 1936; and submitted a draft which was enacted in 1968 without material amendment. The recast provision and its successor (s.104 of the Income Tax Act 1976) set a much wider and more commercially realistic test of deductibility of expenditure. But this appeal falls for determination under the old and narrower provision. As is emphasized in the cases, little assistance in applying its provisions is to be derived from decisions on the differently phrased and wider deduction provisions of the English and Australian income tax statutes. See, for example, Ward & Company Limited v. Commissioner of Taxes (1923) A.C. 145; and Kemball v. Commissioner of Taxes (1932) N.Z.L.R. 1305.

The first requirement to be satisfied under the old s.111 is that the expenditure be "exclusively incurred in the production of the assessable income". It was well settled

that the test, or at least the generally appropriate test, of deductibility under that provision was the purpose of the expenditure. Ward & Company Limited v. Commissioner of Taxes; Aspro, Limited v. Commissioner of Taxes (1932) A.C. 683; and Commissioner of Inland Revenue v. Europa Oil (N.Z.) Limited (1971) N.Z.L.R. 641. It is not necessary that the taxpayer should have earned sufficient assessable income to cover the deductions claimed. It is sufficient that they were incurred for the purpose of producing assessable income.

But there is a fundamental distinction between the source of income and the income earning process. Expenditure to make the future earning of profits possible is of a different character from expenditure incurred as part of the process of earning profits. Where this type of distinction arises for consideration on the facts, the deduction is usually challenged on two grounds: that the expenditure is capital barred from deduction under s.112(a), and alternatively that it does not meet the test under s.111. The arguments tend to overlap in so far as they focus on the relationship between the expenditure and the current operations of the business as affecting the revenue character of the expenditure, and it is often found convenient to consider them together. Any such expenditure which is exclusively incurred in the production of the assessable income will not ordinarily be regarded as an investment of capital and, if deductibility is excluded under s.111, it is not necessary to determine whether it is also barred by s.112(a).

A number of points arising from the argument should be noticed at this juncture. First, there are three matters

which were given some emphasis in the speech of Lord Wilberforce in the first Europa Oil case at pp. 648-649. The first is that the Crown is not bound by the taxpayer's statement of account, or by the heading under which expenditure is placed: it is entitled to ascertain for what the expenditure was in reality incurred (p.648). The second is that the form of the New Zealand s.111 entitles the Commissioner to apportion expenditure between what is exclusively incurred in the production of assessable income and what is not (p.649). The third is that a trader is entitled to conduct his business in his own way and it is not for the Court or the Commissioner to say how much a taxpayer ought to spend in obtaining his income, but only how much he has spent (p.649).

In addition, it must be recognized that all the expenses in question were current and recurrent outgoings in relation to the properties. Unlike the direct costs of acquisition of an enduring asset they do not have an inherently capital stamp. No doubt it was for this reason that counsel for the Commissioner did not advance a separate argument against deductibility under s.112(a). So it becomes necessary to consider the role and function of the particular asset in the particular income year - whether it was committed to income earning activity and, if so, how it was employed in the production of the assessable income of the year, whatever use was ultimately contemplated of the asset in the income earning process. All the expenses in question were servicing expenses in relation to the particular properties. The purpose for which a property is initially acquired is a relevant consideration but it is not determinative of deductibility of

current outgoings under s.111. The concern of the section is with the relevant factual situation at the time the expenditure for which deduction is sought is incurred, rather than what may have been the position in respect of the property at an earlier or a later date. (C.I.R. v. Banks (1978) 2 N.Z.L.R. 472, 477)

This leads us to the final matter calling for comment at this stage. It is simply that this was an existing business and so the various cases on start-up expenses in relation to new businesses, not all of which are easy to reconcile with each other, are not a helpful guide to the resolution of the present case.

The factual answers

Against that background we turn to consider the manner in which each of the properties in question was employed in the relevant income years and, in particular, the relationship between the expenditures in question and the trading operations of the appellant.

First, Horomatangi Street, Taupo. The section was quite close to the company's grocery and hardware store. Until that store was closed about August 1964, early in the first income year under review, the section was used as a car-park for customers and staff. It was committed in that way to the current operations of the appellant's business. Following the concentration of the Taupo business at the Atiamuri site, the Horomatangi Street section was retained as a car-parking facility for farming customers and was also used by staff in the course of the company's business. With respect to

Ongley J., we do not regard as irrelevant the goodwill benefits flowing to the appellant from the use of the car-park by customers of the company in this way, and on our reading of the evidence we conclude that the use of the section during each of the income years in question represented a continuing employment of that property as part of the current operations of the appellant's business in Taupo. That being so, the modest servicing expenses for which deductions have been claimed are properly to be regarded as expenses incurred in the production of the business income of the appellant.

The evidence in the case does not warrant the drawing of like inferences in respect of the expenses incurred in the years in question in relation to the other two properties. There is no evidence that the 7-acre industrial site at Napier was used in any substantial way in conjunction with the business of the company during the years in question. In the last year, the 1968 year, a barley crop was sown and harvested. The proceeds barely covered the direct expenses involved. That use was clearly not a use of this industrial land which was directly related to the ordinary business operations of the company. The only other use of the land which may have occurred during the income tax years in question which is adverted to in the evidence is for the holding of stock overnight between stock sales. It is not clear that this happened at all during these years, for the evidence in chief of the General Manager simply records, following a reference to a use of the land which occurred in later income years, that it was also used for this purpose "from time to time", although in cross-examination he thought it had been used for that purpose

prior to 1967. Indeed, Ongley J. found that nothing was done with the land until October 1967 when the barley crop was sown. In any event, there is no basis in the evidence for a finding that there was a sufficiently substantial use of the property in conjunction with the stock and station business during the income years in question to justify the inference that the property had been committed to the continuing trading operations of the appellant.

It was never intended that the full 3½ acres at Hastings should be used in the business of the company. It was intended from the outset that the house and the bulk of the land would be subdivided off and sold. The house was let pending realization. An undefined area of land was rented to a neighbour in the meantime. The only what we might call "ordinary" business use of any part of the property was for the occasional storage of posts and battens for the produce department. On the evidence in the case we consider that this proved use is altogether too unsubstantial to serve as the basis for a finding that the Hastings land or any identifiable part was employed in the trading operations of the appellant during the income years in question.

The second question that arises under s.111 concerns the statutory nexus between the expenditure and the production of the assessable income for any income year in order for that expenditure to be deducted from the total income for that year. However, on the approach we have taken to the first issue, it is not necessary to consider the restrictive effects of the section where the expenditure in question is directed to the production of income in future years that were con-

sidered in this Court in Kemball v. Commissioner of Taxes and Auckland Trotting Club (Inc.) v. C.I.R. (1968) N.Z.L.R. 967. This is because in so far as the expenses in question were referable to the employment of the Taupo section in the current operations of the business of the appellant they were incurred in the production of the income of the business for the income year in question; and the expenses of servicing the Hastings and Napier properties, which were not shown to have been employed in the appellant's business in those years, were not incurred as part of the income earning process.

The appeal is accordingly allowed in part. In lieu of the order made in the High Court it is determined that the Commissioner acted incorrectly in making the amended assessments referred to in the case stated and that those assessments should be amended by allowing the expenditures on rates and land tax incurred by the appellant in relation to the Taupo property as deductions in calculating the assessable income of the appellant for the respective income years.

In all the circumstances there will be no order as to costs.

SOLICITORS:

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