20/12 NZLR

IN THE COURT OF APPEAL OF NEW ZEALAND CA.151/80

BETWEEN THE COMMISSIONER OF INLAND REVENUE

Appellant

MEDIUM PRIORITY

150

A N D THE FARMERS' TRADING COMPANY LIMITED of Auckland

Respondent

Coram Richardson J (presiding)
McMullin J
Bisson J

Hearing 18 November 1988

Counsel P.J.H. Jenkin QC for appellant
R.L. Congreve and R.A. Green for respondent

Judgment 16 December 1988

JUDGMENT OF THE COURT DELIVERED BY RICHARDSON J

This case is a belated sequel to the decision of this Court delivered on 2 July 1982 and reported at [1982] 1 NZLR 449. That decision upheld the Commissioner's contention that the Farmers Trading Co Ltd was not entitled for income tax purposes to defer recognition of the gross profit content of instalments in respect of its twenty week budget account sales not payable at balance date to the next year in which they became payable. Compared with an accounting method which brings all receivables into account in the year of sale the company in respect of its budget account sales: (i) omitted 40% of the instalments not due until the following year; but (ii) included 40% of the instalments due for payment in the current year in respect of sales made in the previous year. The effect was to defer to the following year the gross profit content of the additional instalments due post balance date resulting from increased sales in each year. It was the difference between the gross profit content of closing debtors and opening debtors respectively and it amounted to $20,8000 in the income year in question ending 31 March 1976.

The company had followed that accounting practice since around 1930. The budget account sales turnover had increased very considerably over the years and the instalments payable after 31 March 1975 in respect of sales during the year ended 31 March 1975 amounted to $828,096. The Commissioner was time-barred from reopening all the earlier years but invoked s.92A of the Land and Income Tax Act 1954 as authority for spreading that closing balance of the 1975 year over the succeeding four income years ended 31 March 1976 to 31 March 1979 both inclusive.

The case was eventually remitted by this Court to the High Court ((1982) 5 NZTC 61,321) and two matters were argued before Prichard J and dealt with in his judgment of 3 December 1985 now reported at (1985) 8 NZTC 5062. The first was whether the gross profit content of instalments not receivable at or before the balance date of the year of sale should have been brought to account in the year of sale at less than face value. In accordance with the unanimous view of the experts engaged by the parties the profit content was fixed at the face value. Accordingly the Commissioner's assessment for the 1976 income year insofar as it included $18,323 (the $20,800 less a credit charge of $2,477) in the assessable income for that year was upheld. That is not in issue on this appeal.

The second was whether s.92A entitled the Commissioner to spread the closing figure of the 1975 year of $828,096 over the succeeding four years. That turned essentially on the application of the provisions of s.92A(1)(b) and (f) to the facts of the case. Applying Inland Revenue Commissioner v. National Bank of New Zealand (1976) 7 AITR 282, Prichard J held against the Commissioner. The Commissioner now appeals.

The section

The 1954 legislation was repealed by the consolidating Act, the Income Tax Act 1976, s.76 of which is in the same terms. But in respect of the 1975 and 1976 income years the material provision was s.92A(1) of the 1954 Act which read as follows:

> **Adjustment for incorrect accounting practice in previous years -**
>
> (1) Where the Commissioner, in calculating the assessable income of any taxpayer derived from any business in any income year (that income year being

referred to in this section as the year of adjustment), is satisfied that the assessable income of that taxpayer in any income year or years (that income year or, as the case may be, those income years being referred to in this section as the preceding period) preceding the year of adjustment has been understated or overstated by reson of the profits or gains from that business having been calculated -

(a) By reference to cash receipts or outgoings and without taking into account amounts owing to or by the taxpayer at the beginning or end of any income year in the preceding period; or

(b) By taking into account provisions or reserves which are not deductible under this Act in calculating those profits or gains; or

(c) Without taking into account provisions or reserves which are deductible under this Act in calculating those profits or gains; or

(d) By incorrectly allocating or apportioning between capital and income amounts received by the taxpayer in respect of any transactions not completed at the end of any income year in the preceding period, -

the Commissioner may, in calculating the assessable income derived by the taxpayer in the year of adjustment, first determine the amount which would have been the assessable income derived in that year if the profits or gains for any income year in the preceding period had not been understated or overstated by reason of any of the matters referred to in paragraphs (a), (b), (c), and (d) of this subsection and then make adjustments to that amount for the understatement or, as the case may be, the overstatement for the preceding period -

(e) Where paragraph (a) of this subsection applies, by adding the amounts owing to the taxpayer at the end of the preceding period and subtracting the amounts owing by the taxpayer at the end of the preceding period, being in either case the amounts referred to in that paragraph; and

(f) Where paragraph (b) of this subsection applies, by adding the amount of the provisions or reserves at the end of the preceding period; and

(g) Where paragraph (c) of this subsection applies, by subtracting the amount of any provisions or reserves which could have been made at the end of the preceding period; and

(h) Where paragraph (d) of this subsection applies, by adding any amount which, by reason of the method of

> apportioning between capital and income previously followed, had been omitted from the income of the preceding period, and by subtracting any amount which, for the same reason, had been incorrectly included in the income of the preceding period, being in either case an amount in respect of transactions not completed at the end of the preceding period, -

and the adjusted amount shall be deemed to be the amount of the assessable income derived from the business in the year of adjustment.

Subsections (2) and (3) provided machinery for spreading the amount of the adjustment over a period of four years. That course was followed in this case but nothing turns on those provisions.

The issues

Three questions were canvassed in argument. The first was whether the gross profit content of the instalments due post balance date was within the expression "provisions or reserves" in (b) and (f); the second was whether any such items had been deducted in calculating the profits or gains from the business of the company; the third was whether in the result the Commissioner had applied s.92A according to its terms. In considering those questions it is helpful to have in mind the accounting practice actually adopted by the company.

The accounting treamment

From the inception of budget account sales the company included those sales and hire purchase transactions together with the profit in each case being recognised on a profit emerging basis. Thus they are included in but not separately identified in the balance sheet item "Less Provision for Unearned Profit and Interest on Time Payment Debtors" as a deduction from "Sundry Debtors" in the "Current Assets" column. There is a corresponding item in the Profit and Loss Account "Adjustment to Provision for Unearned Profits and Interest on Time Payment Debtors". In the Consolidated Profit and Loss Account for the year ended 31 March 1976 the adjustment which was shown as a deduction against net profit from trading was $1,014,170, and for the 1975 year it was $95,308.

In furnishing its income tax return the company made various adjustments to its financial accounts to reflect provisions of the income tax legislation. In 1975, this being the year on which the Commissioner relies under s.92A, under the heading "Provision for Unearned Profits and Interest on Time Payment Debtors, Head Office" the opening balance is $3,876,050 to which are added transfers from the Hastings Branch provision and Wanganui Group provision to show a credit of $4,168,717. Then there are two "Six Monthly Adjustments", a credit on 30 September of $192,711 and a debit on 31 March of $114,628 (no doubt reflecting the seasonal nature of the company's business), leading to an overall credit of $78,083 and a closing balance of $4,246,800. Describing the process Mr Robertson, the secretary of the company, said in his evidence that they considered income accrued as instalments fell due and that "the profit on the portion of the sale that had not yet fallen due was deducted from our profits".

As has been noted that "provision" covers both 20 week budget account sales and hire purchase transactions and so, of course, does the $78,083. The amount referable to the budget account sales is not identified in the case but as a net amount it is obviously miniscule by comparison with the $828,096 which the Commissioner claims as a "provision or reserve" in respect of that year. That amount was derived by the Commissioner by reference to the books of the company. It is based on an amount of debtors, excluding arrears, as at 31 March 1975 of $2,350,000, of which the assumed gross profit content of 40% is $940,000 which, after deduction of the credit charge of $111,904, yields $828,096.

Provisions or Reserves

A taxpayer who labels an accounting item a "provision" may not find it easy to deny its own nomenclature. In the end, however, it is for the Court to determine the proper characterisation of the item.

No guidance as to the meaning of "provisions or reserves" as used in s.92A is given in the income tax statute. There are, of course, many statements in the cases testifying to the importance in the administration of the income tax legislation of applying generally accepted accounting principles and ordinary commercial practice in the computation of business income so far as the statutory language permits (see the first decision at p.454). And the familiar accounting expressions "provision" and "reserve", as they apply to accounts of companies for financial reporting purposes, are defined in para 2(1) of the 8th Schedule to the Companies Act 1955 in the following way:

2. (1) For the purposes of this Schedule, unless the context otherwise requires, -

   (a) The expression "provision" shall, subject to subclause (2) of this paragraph, mean any amount written off or retained by way of providing for depreciation, renewals, or diminution in value of assets or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy:

   (b) The expression "reserve" shall not, subject as aforesaid, include any amount written off or retained by way of providing for depreciation, renewals, or diminution in value of assets or retained by way of providing for any known liability:

Clearly it could not be argued that the adjustments made by the company here are amounts written off or retained by way of providing for depreciation or renewals of assets or are amounts retained by way of providing for any known liability. What was contended for the Commissioner, however, was that they were by way of providing for diminution in value of sundry debtors. Two witnesses for the Commissioner, Mr R.E. Martin a departmental inspector and Mr G.W. Valentine, a very experienced chartered accountant who was also a director of another firm of retailers and a past president of the New

Zealand Society of Accountants, supported that view and, as earlier noted, the balance sheet of the company itself records the "Provision for Unearned Profit and Interest on Time Payment Debtors" as a deduction from "Sundry Debtors" in the "Current Assets" column. Mr J.G. Hagan, a very experienced chartered accountant who was a member of the firm of auditors of the company and a member of the Board of Research of the Society charged with establishing standard accounting practices in New Zealand, took a contrary view: in his opinion the calculation did not attempt to diminish the value of the receivables, but rather to measure income. We are satisfied that his is the better view. The scheme of the paragraph in the Eighth Schedule is that an allowance is made for a reduction in the value of an asset. Here the asset itself has been excluded. That was not because of any loss in value but because the gross profit content was considered referable to the next income year.

Mr Valentine added a second reason for his conclusion. It was that in the event of early maturity some of the gross profit content might have to be reversed or rebated. That might perhaps more logically be considered as providing for a known liability within paragraph 2(1) but, as Mr Jenkin for the Commissioner appeared to accept, the necessary factual foundation for Mr Valentine's opinion was not established there being no evidence of any entitlement to or practice of providing a discount for early payment of budget sales instalments. And, as was noted in the first decision (pp.451-2), the adoption of the profit emerging accounting method was not supported by reference to the collectability as at balance date of instalments not yet due.

Finally, although none of the experts suggested that the adjustment could be regarded as providing a "reserve", Mr Jenkin argued in the alternative that it fell within that description in s.92A. In broad terms a provision reflects a charge against profits whereas a reserve reflects an allocation or setting aside of profits for future use or advantage. The distinction is reflected in a provision for depreciation in the one case and a sinking fund for replacement of assets in the other. Neither term is apt to cover a case such as the present where an amount is excluded from income in year 1 and recognised as income in year 2. In short, where the adjustment at the end of any one year is always brought into account the next year.

Were the adjustments deducted in calculating profits

Section 92A(1) does not extend to all understatements or overstatements of assessable income arising from income accounting practices. It is directed to four specifically defined and limited categories. Para (b) refers to the taking into account of a provision or reserve not "deductible" under the Act. It does not extend to cases of omission of income altogether. It necessarily follows, and was so held in Inland Revenue Commissioner v. National Bank of New Zealand, that the Commissioner must be able to point to those revenue items which have been brought to account from which a deduction not authorised by the Act has been made in calculating business profits.

The crucial question is whether the company must be taken to have made an unauthorised deduction in carrying out adjustments to the "provision" in question. If Mr Robertson's evidence is accepted at face value the sale price of the goods sold on the twenty week accounts was brought into the company's books for the purposes of calculating the profits and a deduction was then made in respect of the gross profit content of instalments not due in the current year. Mr Jenkin accordingly argued that the sums in question both came into and then were taken out of the accounts.

The contrary argument for the company is that under the scheme of the income tax legislation the calculation of assessable income involves as a first step the ascertainment of a sum or sums constituting income referable to the particular accounting period and as a second step a deduction from that which, the adjustment aside, constitutes total or gross income of that period. On that approach "deduction" in the statutory sense is not an appropriate term to apply to a calculation made in determining what income was derived during that period.

This approach has the powerful support of the very experienced revenue Judge Thorson P in Publishers Guild of Canada Ltd v. Minister of National Revenue [1957] CTC 1.

That case concerned a profit emerging accounting method and one question was whether it involved the setting up of a reserve or contingent account contrary to s.6(1)(d) of the Income War Tax Act 1927 which provided:

> 6. (1) In computing the amount of the profits or gains to be assessed, a deduction shall not be allowed in respect of
>
> (d) Amounts transferred or credited to a reserve, contingent account or sinking fund, except such amount for bad debts as the Minister may allow and except as otherwise provided in this Act;

Thorson P dealt with the point in this way (pp.27-28):

> The section does not apply to what the taxpayer did. What it prohibits is the deduction from what would otherwise be assessable profits or gains of any amount transferred or credited to a reserve, contingent account or sinking fund, except as permitted. Here there was no such transfer or credit. What the taxpayer did was to exclude from its computation of income for the year the unrealized gross profit of its accounts receivable at the end of the year on the ground that such gross profit did not constitute income for the year that could enter into the computation of profits or gains to be assessed. It was not a case of deduction from income at all.

There is a difference between the two cases. In the Publishers Guild of Canada case Thorson P had already held that, leaving aside the possible application of s.6(1)(d), the profit emerging system of accounting was appropriate to the taxpayer's business and accurately reflected its income for income tax purposes. In short, the gross profit content of the post balance date instalments was not income of that year. Here it was income of that year and ought to have been brought into account. What the company believed it was doing was to calculate, at the first step referred to earlier, what income was referable to the current income year and to exclude altogether future receivables referable to the next income year. Is that enough? As a matter of interpretation the point is clearly arguable, but on balance we consider that the section is directed to what the taxpayer actually did intending to do. The subsection applies where the profits or gains "have [having] been calculated" in one of the then specified ways, which is obviously directed to the actual calculation of the assessable income of the taxpayer. Paras (a) and (d) of s.92A(1) also proceed on the basis of what the taxpayer did: under (a) it is because the taxpayer did not take outstanding debtors or creditors into account and under (d) because the actual allocation or apportionment between capital and income was incorrect in law, that the paragraph applies. In the same way paragraph (b) appears to proceed on the premise that the taxpayer claimed a deduction to which it was not entitled.

The Commissioner's application of s.92A

In view of the conclusions we have already reached it is not necessary to consider the third ground of challenge to the Commissioner's approach under the section, and we shortly note the argument only in case the matter goes further and the point becomes material.

Section 92A is not an independent taxing provision. It allows the Commissioner to make adjustments in a particular year only where the assessable income of an earlier year or earliers years has been understated (or overstated). The first point of difficulty arises from the deemed correctness of assessments in respect of earlier years (s.26) except where reopened or amended within the time limits provided for under s.24 or in circumstances where the section in question displaces those time limits, e.g. sections 85(6), 88C(4), 93(3), 97A(5), 117(2), 121B(2), 129BB(3), 129C(2), 136F(3), 136G(3), 137(2B), 153F(16)(a), 153F(16)(b), 153F(20), 155A(3), and 203K(4).

Section 92A contains no such authorisation for the Commissioner to question the correctness of assessments that are otherwise time barred under s.24 and the argument is that he cannot be satisfied that the assessable income of the taxpayer in any such earlier income year has been understated if he is not entitled to question the assessment for that year. If then the Commissioner had sought to go behind the assessments for all those earlier years back to 1930 - as Prichard J concluded he was attempting to do - it would be necessary to decide that point and there would be the associated difficulties of deciding what, if any, income tax law was applicable in each of the years before the commencement of the Land and Income Tax Act 1954, and of providing evidence of the factual position year by year after such a long lapse of time. However, none of those questions has any potential application in this case because the Commissioner has confined his attention to the income year ended 1975. It is only in respect of that year that he claims to be satisfied that the assessable income of the company was understated. If any part of the $828,096 is not referable to that year he has not sought to argue in the alternative that the profits of any preceding years have been understated. And it is common ground that the Commissioner was not time barred from reopening the 1975 year at the time he invoked s.92A against the company.

The Commissioner's approach under s.92A as reflected in the inspector's statement of adjustment was that the total twenty week debtors at 31 March 1975 amounted to $2,350,000 of which 40% or $940,000 represented the gross profit content and after deduction of the credit charge the "reserve" as at 31 March 1975 amounted to $828,096. Thus the Commissioner's starting point was that the only debts which fell to be considered at all were those where the instalments began within twenty weeks of balance date with the result that one or more instalments became due in the following year. And the Commissioner derived that material not from the financial statements of the company but from analysis of material in its books of account.

The actual accounting process followed by the company was quite different. There were two six monthly adjustments in respect of both twenty week debtors and hire purchase transactions totalling $78,083. Where s.92A(1)(b) is relied on the Commissioner is required under (f) to make an adjustment to the assessable income for the year of adjustment "for the understatement ... for the preceding period [that is the understatement for the income year ended 31 March 1975] ... by adding the amount of the provisions or reserves at the end of the preceding period". The Commissioner relies on that last phrase as justifying taking the closing figure into account. The contrary argument is that, as in the 1976 year where the adjustment was $18,323, the amount of the provision or reserve which was set off against the income of the 1975 year was the difference between the amount owing but not brought into account at the end of that year and the total amount owing at the end of the previous year and which was brought into account in that year. That is the amount of the understatement of profits for the 1975 year and to take the $828,096 as the provision grossly overstates the understatement for the 1975 year. Again the point is arguable either way, but we are inclined to the view that the legislation could not have intended such a distortion of the actual understatement for the preceding year and that the provision or reserve in existence at the end of a period in a case such as this must be taken as being the net adjustment for that last year. That recognises the reality that all provision amounts have always been brought into income in the immediately succeeding year.

For the reasons given the appeal is dismissed. The company is entitled to costs on the appeal which are fixed at $2,000 together with all reasonable disbursements as fixed by the Registrar including the travelling costs of both counsel.

Solicitors

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