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IN THE HIGH COURT OF NEW ZEALAND
AUCKLAND REGISTRY

HC.244/94

NOT RECOMMENDED

IN THE MATTER	of the Inland Revenue Department Act 1974	
BETWEEN	HOTDIP GALVANISERS (CHRISTCHURCH) LIMITED (In Liquidation)	
	First Appellant	
A N D	BRIAN PERRY LTD (In Liquidation)	
	Second Appellant	
A N D	THE COMMISSIONER OF INLAND REVENUE	
	Respondent	

Hearing: 23 August 1996

Counsel: GA Muir for Appellants
C Wood for Respondent

Judgment: 16th October 1996

JUDGMENT OF MORRIS J

Solicitors:
Bradbury & Muir, DX CP 23532, Auckland, for Appellants;
Crown Solicitor, Auckland, for Respondent.

Introduction

This is an appeal by way of case stated from a decision delivered by the Taxation Review Authority in December 1994. The case involves three companies and their tax assessments for the years 1981, 1982, and 1983 carried out by the Commissioner of Inland Revenue ("the respondent"). The companies are Les I Russell Ltd ("LIRL"), Hotdip Galvanisers (Christchurch) Ltd (In Liquidation) and Brian Perry Ltd (In Liquidation) ("the first and second appellants"). These companies constitute a specific group for the purposes of s 191(5) of the Income Tax Act 1976.

The Statutory Provisions

At the time of these events the Income Tax Act 1976 was still in force. Pursuant to s 9 of that Act all taxpayers were required to furnish annual returns of all their assessable income. Using this information the Commissioner was then required by s 19 to make assessments of each taxpayer's liability. The Commissioner was further required to assess any losses claimed and whether they could be carried forward to a later income year. Section 23 gave the Commissioner power to alter assessments if necessary subject to a time limitation in s 25.

Section 191 provides for the special treatment of a group of companies. In order to come within the ambit of s 191(5) companies must meet the definition of a "specified group" in subs (4). Section 191(5) provides that a company which has suffered a loss can nominate another company in the group to have the loss either wholly or partly deducted from its profit. That is it authorises the setting off of losses against profits of companies within a specified group.

> "**191(5) [Deduction of loss of other group company]** Subject to section 188A of this Act and subsection (7A) of this section, where subsection (4) of this section applies to any specified group and to any income year, -
>
> (a) The whole or any part of any loss (not being a loss which consists of a balance of any mining outgoing excess under section 220(6) of this Act) which has been incurred in that income year by any company included in the specified group in that income year; and
>
> (b) The whole or part of any loss (not being a loss which consists of a balance of any mining outgoing excess under section 220(6) of this Act) carried forward to that income year pursuant to section 188 of this Act by any company included in the specified group in that income year so far as that loss or part of a loss has not been deducted from or set off against the assessable income, if any, derived by that company in that income year, -
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> may, if that company so elects by notice in accordance with subsection (5A) of this section, be deducted from the assessable income (other than non-resident withholding income of any of the kinds to which section 318 of this Act applies) derived in that income year by such other company or companies included in the specified group as is or are nominated by that company, so far as the balance of that assessable income (after the deduction by each of those other companies of any loss which it is entitled to deduct under section 188 of this Act) extends, and the amount of the loss or part of a loss of any company so deducted from the assessable income derived by any other company shall not be carried forward in accordance with section 188 of this Act, and any election made in accordance with this subsection shall be irrevocable: ..."

As far as is applicable to the current facts s 191(7B) provides that any deduction made under s 191(5) when calculating assessable income and loss offsets shall be deemed to be a deduction to which ss 188(4) and (6) apply.

> "191(7B) **[Application of sec 188 to deduction]** Any deduction allowable under subsection (5) or subsection (7) of this section from or in calculating the assessable income derived by any company in any income year, in respect of or in relation to a loss or part of a loss incurred by any other company, shall be deemed to be a deduction to which subsections (4), (5) and (6) of section 188 of this Act apply as if that first-mentioned company were the taxpayer referred to in those subsections."

Section 188(4) confers power on the Commissioner to alter an assessment where a taxpayer's liability in respect of debts relating to the calculation of losses is cancelled or remitted.

> **"(4) [Debts subsequently remitted]** Where the amount of any debt incurred by a taxpayer has been taken into account in calculating any loss incurred by him in any income year, and subsequently the liability of the taxpayer in respect of that debt has been remitted or cancelled in whole or in part, the relief afforded by this section shall be reduced by the amount so remitted or cancelled. For the purposes of giving effect to this subsection, the Commissioner may at any time alter any assessment, notwithstanding anything in section 25 of this Act."

Section 188(6) sets out when a debt is to be deemed cancelled or remitted.

> "188(6) **[Deemed remission and cancellation of debts]** For the purposes of this section -
>
> (a) A debt shall be deemed to have been remitted to the extent to which the taxpayer has been discharged from that liability

without fully adequate consideration in money or money's worth:

(b) A debt shall be deemed to have been cancelled to the extent to which the taxpayer has been released from that liability by the operation of the Bankruptcy Act 1908 or the Insolvency Act 1967 or the Companies Act 1955, or by any deed of composition with his creditors:

(c) A debt shall be deemed to have been cancelled to the extent to which it has become irrecoverable or unenforceable by action through the lapse of time."

The issue for appeal is the operation of sections 191(7B) and 188(4).

The Factual Background

The parties do not dispute the findings of fact made by Barber DJ. These can be simply stated. For the income years 1978 to 1983 losses incurred by LIRL were offset against the profits of one of the appellants pursuant to s 191(5) of the Income Tax Act 1976.

LIRL ("the loss company") was wound up on 2 May 1979. Receivers under the debenture had been appointed on 31 May 1977. In the period from 3 February 1977 to 15 March 1993 they had paid $888,824 to the debentureholders. With respect to these payments they made no appropriation as between principle and interest. LIRL was struck off the register on 24 March 1991.

In or about January 1991 as LIRL was in liquidation and soon to be struck off, the respondent determined that the interest deductions which resulted in the company's losses for the 1981, 1982 and 1983 income years were to be treated as interest that had been either remitted or cancelled. The respondent alleged this interest had not been paid. On the basis of this determination the respondent calculated LIRL's assessable income as $20,896 for the 1981 income year, $54,225 for the 1982 income year and a loss of $6,295 for the 1983 income year. No amended assessments or determinations of loss for the 1981, 1982 and 1983 income years in respect of LIRL were issued. LIRL cannot be restored so as to issue amended assessments.

The Commissioner concluded this affected the loss setoffs of the appellants. Accordingly the Commissioner issued an amended assessment for each of the appellants disallowing the deduction in respect of the loss setoff. The Commissioner issued the amended assessments on the grounds that when LIRL was dissolved its assets passed to the Crown as bona vacantia so it became impossible to recover any debts that were still owing. The debts had not been fully repaid but on dissolution the balance owing was cancelled. The losses of LIRL constituted deductions claimed for interest payable on debentures. That interest was cancelled or remitted before being paid. The Commissioner decided that as LIRL had gone into liquidation the debenture interest deductions which resulted in the losses were for cancelled interest.

The appellant's objected to the amended assessments on the grounds that losses of LIRL ought to have been deducted. As no assessment had been issued to LIRL disallowing the deductions, the Commissioner could not disallow the loss offsets to the appellants.

The questions for the determination of the Taxation Review Authority were whether the interest claimed as a deduction by LIRL in calculating its losses in

1981, 1982 and 1983 was remitted or cancelled upon LIRL going into liquidation and if so whether the respondent was correct to issue amended assessments to the appellants for those years treating the interest as remitted or cancelled.

The Authority's Decision

The Authority held that the debt was deemed cancelled by operation of s 188(6)(b) upon the company's striking off. Through the operation of the Companies Act 1955 LIRL was released from its liability under the debenture. In addition under s 188(6)(c) the debt is deemed cancelled to the extent to which it has become irrecoverable or unenforceable by action through lapse of time. The respondent had acted correctly in issuing amended assessments which disallowed the offset of losses.

Neither party disputed that the payments made to the debentureholder were treated as applying to the loan principal and not the interest. For the purposes of s 188(4) and (6) the payments must be treated as applying to the principal. Consequently the interest losses used by LIRL and the objectors were never paid. Liability for that interest was deemed cancelled upon the company's deregistration. The respondent was therefore entitled to amend the loss company's assessments in relation to the expenses comprising previous losses which were not in fact incurred. Pursuant to s 188(4) there was no time limitation imposed on the Commissioner to make the re-adjustments. The Commissioner had not reassessed the company prior to it being struck off and it was now unable to do so.

The Authority stated that s 188 and s 191 must be interpreted so as to give effect to s 188(4) and (6) and s 191(5) and (7B). It interpreted s 191(7B) as allowing the Commissioner to look at s 188(4) and treat the profit company (each appellant) as if it were the loss company. The respondent was entitled to conclude that the profit company had taken an interest debt into account in calculating the loss of the loss company which the profit company used even though it had not incurred that loss itself. As that interest debt had been remitted or cancelled, the deductibility of the interest payment must be reduced accordingly.

On the Authority's interpretation of the link between s 191(7B) and s 188(4) the respondent was permitted to alter the assessments of the profit companies at any time to give effect to the amended assessment of the losses incurred. The respondent was not required to issue an amended assessment for the loss company first.

The Authority also held s 78 applied to neither objector.

Issues On Appeal

The questions for determination are first whether the Authority was correct in finding that the Commissioner had acted correctly in making amended assessments of the first appellant for the income years ending 31 March 1982 and 1983 which disallowed the offset against its assessable income pursuant to s 191(5) of losses incurred by LIRL. Second whether the Commissioner had acted correctly in making amended assessments of the second appellant for the income year ending 31 March 1981 which disallowed the offset against its assessable income pursuant to s 191(5) of losses incurred by LIRL.

Third whether s 191(7B), which deemed a deduction under s 191(5) for the offset of the loss of another group company to be a deduction subject to s 188(4), (5) and (6), enabled the Commissioner to issue amended assessments on 1 July 1991 for the first and second appellants disallowing the offset of the losses where the respondent had not issued amended assessments for LIRL disallowing its losses for the relevant years and that company having since been struck off the register of companies on 24 April 1991.

Submissions for the Appellants

The appellants submit where any loss offset initially taken by an income company subsequently becomes unavailable as a result of the loss company failing to satisfy s 191(7A) or by operation of s 188(4) there is no specific provision in s 191 for amendment of assessment in relation to the income company. The general provision for amendment in s 25 must apply which contains a 4 year time limit. Where such offset becomes unavailable outside the four years, s 191(7B) purports to deem the deduction for the loss offset to be subject to s 188(4) and for s188(4) to apply to the income company "as if" it were the taxpayer referred to in s 188(4).

The appellants also submit the policy behind s 191(7B) is to provide a mechanism for reversing losses which have been transferred from a loss company to an income company, if those losses were later shown to be have been not available. This would occur but s 191(7A) would not apply where there was a remission of a debt two to three years after the loss transfer which, upon reassessment of the loss company, effectively reduced that company's losses in the years which those losses had been transferred to the income company. Without s 191(7B) the Commissioner would not have the ability to adjust the loss offset by the income company even though he had the ability to adjust the deductions allowable to the loss company.

The appellants further submit ss 78 and 191(7A) do not apply. The only other section referred to in the grounds of assessment is s188. Section 188 can only apply to a deduction for a loss offset taken by either appellant through the operation of s 191(7B). Section 191(7B) requires there to be a deduction allowable under s191(5) or (7) from or in calculating assessable income derived by a company in a year. That is, the deduction for the appellants from the transfer of the loss between LIRL and the appellants. Sections 188(4), (5) and (6) apply to those deductions but s 188(4) and (6) do not refer to deductions. The appellant contends it would not make sense for s 188(5) to refer to the deduction in s 191(7B). It deals with situations where a taxpayer is denied a deduction but later pays the debt.

The appellants submit that s 191(7B) should be interpreted as applying to a deduction which a taxpayer would have made under s 188(4) when incurring debt and using that outgoing in calculating his loss. Section 188(4) has no force here because the losses of LIRL are available to the appellants. On the correct interpretation of s 191(7B) the appellants contend it is merely a mechanical provision to ensure s 188(4) applies to the loss deduction claimed by the income company. "[S]hall be deemed to be a deduction to which s 188 (4), (5) and (6) of s 188 of this Act apply" in s 191(7B) does not refer to a deduction which has been cancelled because if it did no loss offset could ever be claimed by any income company. It only refers to a deduction which might as a result of a subsequent cancellation have to be written back. The appellants contend there is no deduction here incurred by either LIRL or the appellants which can be used to alter an assessment.

Submissions of the Respondent

The respondent submitted that the Commissioner should have issued amended assessments for LIRL disallowing the interest payments expenditure. However the Commissioner was unable to do that. He could only disallow the appellants' loss offsets.

Sections 188 and 191 should be interpreted so as to give effect to s 188 (4), (6) and s 191(5), (7B). Any loss deductible under s 191 is determined in accordance with s 188. Section 188(4) should be interpreted as meaning where a debt has been taken into account in calculating a loss and the liability of the taxpayer with respect to that debt has been cancelled, the loss to be carried forward is to be reduced by the amount cancelled. Section 191(7B) provides where a loss incurred by one company in a group has been deducted by another company, that loss is deemed to be a deduction in terms of s 188(4) and (6). The effect of s 191(7B) and s 191(5) is the liquidation of a group loss company can jeopardise the previous loss offset or subvention payments which were utilised in the reduction of profits of a profit company.

So the respondent contends that if the interest claimed as a deduction by LIRL remained unpaid when the company was dissolved, then the debt in respect of that interest would be deemed cancelled by s 188(6). Section 191(7B) gives the Commissioner power to alter the assessments in which the appellants were allowed deductions for the losses incurred by LIRL in those years. The Commissioner had power to alter an assessment to give effect to s 188(4) and s 191(7B) and was not restricted by any time limit imposed by s 25.

The respondent alleges the interest claimed as a deduction was never paid because payments that were made were put towards the principal rather than interest following the presumption in ***Clayton's Case*** (1816) 1 Mer 572. The respondent also referred to ***Bank of New Zealand v DFC of NZ*** [1988] 1 NZLR 495 (CA) in which ***Clayton's Case*** was approved and followed. The Court held if neither the debtor nor creditor has made an election regarding payment then how the creditor actually dealt with the appropriation will be treated as the actual appropriation. As the payments were less than the principal owing, they never touched the interest. Applying ***Clayton's*** rule, the unpaid debt on dissolution was interest.

Decision of this Court

To determine whether the Authority was correct in finding the Commissioner had acted correctly in making amended assessments for the appellants disallowing the loss offsets, it is necessary to examine whether the Commissioner was entitled to make the amended assessments of the appellants. If he was then the issue is whether he was required to issue the loss company with an amended assessment disallowing the losses first.

The matter is one of statutory interpretation of ss 188 and 191. The respondent referred me to ***CIR v Alcan New Zealand Limited*** [1994] 3 NZLR 439 for the correct approach to statutory interpretation. Words in a statute are to be given their ordinary meaning, but if one more than one meaning is possible and the object of the legislation is clear, then the words are to be given such fair large and liberal construction as will best promote the objects of the Act. The Legislature will not have intended absurdity or injustice. Regard must be had to the total context of the words used and the purpose of the legislation. This approach is well established. It is of course necessary when interpreting ss 188 and 191 to aim to give effect to the Act and in particular to the provisions directly concerned. The correct interpretation would not render ss 188(4) and (6) and ss 191 (5) and (7B) superfluous or without effect.

The starting point is s 188(4). Where a taxpayer includes a debt in the calculation of losses and liability for that debt is later either remitted or cancelled, the loss offset will be reduced by the amount remitted or cancelled. The Commissioner can make amended assessments at any time to give effect to this. LIRL included interest owing on debts to debentureholders in calculating its losses for the years 1981, 1982 and 1983. Those debts are deemed cancelled under s 188(6) to the extent to which LIRL was released from that liability by the operation of the Companies Act 1955. This occurred when the company was struck off the Register of Companies. The issue is whether the interest had been paid prior to the company going into liquidation or not. I will return to this shortly.

Section 191(5) provides that subject to s 191(7A), a loss incurred by one company in a group of companies may be deducted from the assessable income of another company in the same group. Both the appellants used this section to take advantage of losses incurred by LIRL to reduce their assessment incomes for the relevant years thereby reducing their tax liabilities.

Section 191(7B) provides any deduction of a loss incurred by another company in the group in calculating income shall be deemed a deduction to which s 188(4), (5) and (6) apply as if the company (the profit company) was the taxpayer referred to in those sections. The effect of this is to allow the Commissioner to apply s 188(4) to the appellants and issue adjusted assessments in respect of them. The appellants submitted this could not be the correct interpretation of the sections as s 188(4) does not refer to a deduction. In my view, while it is true that s 188(4) does not directly refer to any deduction, in order for s 191(7B) to make sense, the deduction of a debt or loss by the taxpayer must be considered such a deduction. That being the case, the loss offsets the appellants made were deductions to which s 188(4) does apply. The Commissioner can issue amended assessments to the appellants.

Once the profit companies are placed in the position of taxpayer for the purposes of s 188(4) it is clear that no reassessment is required for the loss company in order for the profit companies to be reassessed. The Commissioner can reassess the profit companies at any time to reflect the decrease in loss offset by the cancellation of the original debt.

Having decided that the Commissioner is entitled to make amended assessments for each company, I turn now to look at whether that was necessary in the present case.

LIRL had interest obligations on debts to debentureholders. Those interest obligations were included in the assessment of LIRL's losses for the income years 1981, 1982 and 1983. Both of the appellants offset losses of LIRL's against profits for those years pursuant to s 191(5). Before s 188(4) applies there must be either the remitting or cancellation of those losses. Some payments were made by the receivers or liquidators to one of the debentureholder. If these payments went towards the interest obligations then that interest was paid and liability for it could not subsequently be remitted or cancelled. If the payments however went towards reducing the principal owing then the interest expenses that were claimed were never paid. LIRL was still liable for them at the time of being struck off so that liability would have been cancelled pursuant to s 188(6). There was no election made by either the debtor or creditor at the time of payment as to what the payments were for.

The parties did not dispute before the Authority that the payments made by the receivers or liquidators to the debenture holder be treated as having applied to principal rather than to interest. The Authority held this meant the basis of the losses, being LIRL's interest commitments to its debenture holders which the appellants had used as loss offsets, had not been reduced. Barber DJ considered the parties had correctly relied on the rule in ***Clayton's Case*** (1816) 1 Mer 572. As neither the receivers nor the debenture holder made an appropriation, the first debit item is discharged or reduced by the first credit item.

The appellants now dispute the application of the ***Clayton's Case*** presumption. They submit it only applies where there are competing claimants for one sum of money. This could be either two different accounts or equal priority claims to which the money can be appropriated. Further they submit it only applies where there is no appropriation by either debtor or creditor. Addressing this point first, there is no evidence of any appropriation made by either debtor or creditor. Had there been an appropriation by either party then that would determine the matter as to whether or not the interest was paid and there would be no question as to whether the presumption in ***Clayton's Case*** applied.

From a reading of the case itself and a number of cases that have relied on the ***Clayton's Case*** rule, I do not consider the appellant's submissions to be an accurate understanding of when the rule is applicable. The rule has been discussed in 9 Halsbury's Laws of England (4th ed) para 507:

> "Prima facie, the right of appropriation by the creditor does not arise in the case of an account current, that is to say, where there is one entire account into which all receipts and payments are carried in order of date, so that all sums paid in form one blended fund. In such a case the presumption is that the first item on the debit side of the account is intended to be discharged or reduced by the first item on the credit side, and that the various items are appropriated in the order in which the receipts and payments are set against each other in the account.
>
> This presumption, however, may be rebutted by evidence of an agreement to the contrary or of circumstances from which a contrary intention is to be inferred..."

Master Hansen has also summarised the rule quite neatly in ***Telecom Equipment Supplies Ltd v Dreaneen*** (HC, Auckland, CP 396-93, 25 June 1991, Master Hansen) at page 2:

> "*Clayton's Case* (1816) 35 ER 781 established that the person paying money has the primary right to say what account it is to be

> appropriated to. If no appropriation is made at the time of payment then the creditor has the right to appropriate. Subject to the right once an appropriation has been made it cannot subsequently be altered. If neither party exercises the right of appropriation one must look at the account and see how the creditor has dealt with it. In the absence of any specific appropriation it is assumed that the first sum paid in is credited against the first debit item which is thereby discharged or reduced as the case may be. It is common ground between the parties that the rule has application in New Zealand and the principles are applicable to guaranteed debts.
>
> It is also well settled law that the presumption in ***Clayton's Case*** may be displaced by evidence to the contrary. It must be subject to any express contrary intention or to circumstances which point to a contrary conclusion. It is unnecessary to cite the well known authorities for these propositions."

Clayton's Case concerned the situation of a banker and customer and how drawings on the customer's account were to be attributed. The court found there to be no evidence of a contrary intention that the first payments were to go to the earliest debt. To apply ***Clayton's Case*** there must be a relationship of debtor and creditor. In ***The Mecca*** [1897] AC 286, it was held there needs to be a current account and a series of credits and debits in that account which formed an ongoing transaction between the parties.

In the present case there is a relationship of debtor and creditor, there is a current account between the parties to which there were regular debits and credits forming an ongoing transaction and there was no evidence of a contrary intention. Thus all the elements are present to apply ***Clayton's Case***. There is no requirement as alleged by the appellants for there to be competing claimants of equal priority of two different accounts to which the money could be appropriated.

In ***Evans v JF Watson & Co Ltd & Anor*** (CA, 20/3/92, Richardson, McKay & Greig JJ, CA 288-90) one of the issues on appeal was the way in which payments had been appropriated by the creditor. The claim was in respect of money due for logs supplied by the first respondent and for interest. The appellants contended that the payments should have been appropriated to the purchase price of the logs thereby reducing the amount of interest. The respondents contended that the payments be appropriated to interest first and then to the principal. The respondents had been calculating interest on the basis of compound interest. The appellant's account was operated as a current account with purchases and interest being debited and payments credited, and with subsequent interest being calculated on the final balance. McKay J stated at page 8:

> "In this situation it could be contended that the proper course would be to apply the payments simply to the earliest debits of whatever kind in accordance with the rule in ***Clayton's Case***: see ***Fahey v MSD Speirs Ltd*** [1973] 2 NZLR 655. Neither party submitted that Clayton's Case should be applied, however, and we therefore do not propose to go further into that question."

The issue as to appropriation of payments had arisen in relation to the question whether interest was to be charged as simple or compound interest. The respondents had given the appellants detailed calculations of the amount owing based on simple interest. Those calculations clearly showed that payments were to be applied to interest in priority to principal. The Court held the respondent's clear appropriation should apply.

In ***McMahon v McMahon*** [1990] NZLR 37, 45 Greig J said in the context of a matrimonial proceedings:

> "In my opinion, the rule in ***Clayton's Case*** ought to be applied as a sensible and just rule in the absence of any actual appropriation and in the absence of any circumstances which raise a contrary inference."

I adopt the same approach. All the elements are present to apply the presumption in ***Clayton's Case*** and there is no evidence of any contrary intention.

The appellants submit the presumption in ***Falk v Haugh*** (1935) 53 CLR 163 is the correct one to apply in the present case. They submit the Court held in that case where payments are received generally for debts which are part interest and part principal and no election is made, they are treated as applicable to interest in priority to principal. I read the presumption in ***Falk v Haugh*** as applying only to the application of payments in respect of mortgage moneys. The mortgagee had received rents and profits to which the presumption was applied that those monies are deemed to apply to paying the interest owing before repaying the principal. The presumption appears to be intended to protect the mortgagor's position while at the same time safeguarding the mortgagee.

I conclude that the Commissioner did have the authority to alter the appellants' assessments as he did. There was no time limit on him in doing so. The presumption in ***Clayton's Case*** applies. The first debt incurred was the principal which was not fully paid off so the interest was not paid at the time the company was struck off. That interest was claimed as a deduction in calculating LIRL's losses for the relevant years. Liability for that interest was later cancelled when the company was stuck off. Pursuant to s 191(7B) the losses of LIRL that were used by the appellants may be reduced by reassessment of each appellant. I hold that the respondent acted correctly in taking that course of action. The Commissioner is entitled to costs which I fix at $3000.00 together with disbursements including photocopying.