THE EUROPA OIL DECISION

In contemporary times, utilisation of taxation provisions to maximum advantage is common, and the precise scope of certain provisions has assumed major significance. It is in recognition of this development that section 111 of the Land and Income Tax Act 1954, concerning allowable deductions, will be examined, in conjunction with the recent decision of the Privy Council *I.R.C.* v. *Europa Oil (N.Z.) Ltd.*[1] in which the section was considered.

The relevant provisions read as follows:

> s. 110 Except as expressly provided in this Act, no deduction shall be made in respect of any expenditure or loss of any kind for the purpose of calculating the assessable income of any taxpayer.
>
> s. 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.

Provisions of this nature are of major importance to the commercial world, since large amounts may be saved from the hands of the Commissioner if expenditure can be brought within the context of s. 111. It has recently been amended[2] in order to render it less restrictive and more akin to the English and Australian provisions, and the effects of this amendment will be considered at a later stage. But before this an examination of the decision in the Europa case will be made, since it raised several important questions which remain in issue under the new section, although it involved the application of the old provision (see above).

THE FACTS OF THE EUROPA CASE

(a) *Series of Contracts between Europa and Gulf*

Europa Oil (N.Z.) Ltd. (Europa) carried on the business of marketing petroleum products in New Zealand, and it obtained the bulk of its supplies of petroleum products, and later feedstocks, from Gulf Oil Corporation (Gulf). In 1956, Europa entered into three groups of contracts contemporaneously either with Gulf or with one of its subsidiaries:

(a) Petroleum Products Sales Contract, for the supply of gasoline and such gas oil as Europa should require. The contract was for a period of ten years, and the price to be paid for the gasoline was the lower of two quotations as published in Platt's Oilgram, known as 'posted prices'.[3]

1. [1971] 2 W.L.R. 55; [1971] N.Z.L.R. 641.
2. Land and Income Tax Amendment Act 1968, s. 12.
3. These were in fact the current market prices prevailing.

(b) Contract of Affreightment. Gulf agreed to transport the products to New Zealand by tanker at Europa's expense.

(c) Contract for Organisation of Pan Eastern Refining Co. Ltd., (Pan Eastern), a Bahama Corporation, also setting out a Processing Contract between Gulf and Pan Eastern. The Organisation Contract provided for the incorporation of Pan Eastern with capital of £100,000, fifty per cent of this being met by each party to the Contract. In fact, Europa's share was taken up by its wholly owned subsidiary, Associated Motorists Petrol Co. Ltd. (A.M.P.).

The Processing Contract provided for the purchase by Pan Eastern at posted prices of sufficient crude oil to produce gasoline required under the Petroleum Products Sales Contract. This was to be processed for Pan Eastern for a fee at unspecified refineries provided by Gulf. It was also provided that Gulf would buy these products from Pan Eastern at posted prices and would pay Pan Eastern, for products other than gasoline, a price sufficient to ensure net earnings for Pan Eastern in terms of a formula.

The processing was therefore actually done by Gulf, which invoiced Pan Eastern with sufficient crude oil, at posted prices, to meet the gasoline supplied to Europa. At the prices current when the contract was entered into in 1956, Europa's share, through A.M.P., of Pan Eastern's profit was 2.5 cents per gallon of gasoline purchased by Europa.

However, changes in crude and product prices subsequently reduced the intended profits of Pan Eastern and, following negotiations in 1959, the Processing Contract was varied retrospectively so as to guarantee a minimum return to Europa of 2.5 cents per gallon.

In 1962, in the face of the New Zealand Government's decision to set up a refinery in New Zealand, new contracts were negotiated to obtain certain other feedstocks, but these were superseded in 1964 by contracts having a similar effect to the original contracts. These were in turn varied in 1965 so as to give price reductions in the price of crude oil, supplied to Europa Refining, a member of the Europa group, and the prices paid by Gulf to Pan Eastern were proportionately reduced.

(b) *Contracts between Europa and B.P.*

In 1961, an agreement was made whereby B.P. (N.Z.) Ltd. agreed to supply Europa with supplies of gas oil, lighting kerosine and fuel oil in New Zealand at or related to posted prices plus freight.

In 1962, another B.P. concern, B.P. Trading Ltd. (U.K.) agreed with Pacific Trading & Transport Co. Ltd. (P.T.T.), a wholly owned subsidiary of Europa, that in consideration of P.T.T. having procured a contract for supply between Europa and B.P. (N.Z.) Ltd., B.P. Trading Ltd. would pay to P.T.T. a ten per cent commission on each delivery of the products under the supply agreement.

The primary concern of the courts in this litigation was with the first set of contracts with Gulf, for the contracts involving B.P. were largely seen as involving identical issues, and consequently it is with the first series of contracts that this discussion will be primarily concerned.

THE OPPOSING ARGUMENTS

The Commissioner, in his assessment of Europa to income tax, disallowed as permitted deductions under section 111 those amounts of expenditure which were in his view effectively returned to Europa, through its subsidiary's half share in Pan Eastern's profits and through the receipt by another of its subsidiaries (P.T.T.) of commissions on certain products purchased by Europa.

The Commissioner contended that the total expenditure claimed as a deduction was not 'exclusively incurred in the production of the assessable income' as required by s. 111, but that it was incurred for the separate and dual purpose of producing a return to Europa through Pan Eastern and P.T.T. respectively.

Counsel for Europa denied the existence of a dual purpose in the expenditure, and submitted that Europa was compelled to pay posted prices, since discounts were unobtainable. The indirect benefit obtained by Europa from Pan Eastern was not in substance such a discount, but was instead a by-product of the main agreements, arising from Europa's genuine desire to participate in the refining sector, which attracted its own tax incidence.

The question whether the expenditures concerned, whereby Europa got a return on its initial outlay, could be disallowed as a deduction to the extent of such a return, involved several crucial questions in regard to the precise meaning and scope of s. 111, and these questions will be treated in the order in which they were submitted to the court.

The following submissions were made:[4]

(1) that the appropriate test of deductibility was whether the expenditure in question was exclusively incurred in producing the assessable income of Europa;

(2) that the test of deductibility of expenditure under s. 111 was narrower than the test applied in the United Kingdom and Australia;

(3) that while the Commissioner could not challenge the wisdom of an expenditure, he could question its purpose;

(4) that expenditure could be apportioned where it was incurred for two or more purposes, a deduction being allowed in respect of that part which was exclusively incurred in the production of the assessable income of the taxpayer;

4. [1970] N.Z.L.R. 321, 336.

(5) and that, applying these principles of law to the facts, the expenditure by Europa on petroleum supplies obtained from Gulf and B.P. was incurred for two purposes:
  (i) for the purpose of procuring supplies for Europa and thereby producing its assessable income, and
  (ii) for the purpose of producing a return to Europa through Pan Eastern and P.T.T. respectively and that such part of the expenditure was not deductible.

It should be noted, prior to consideration of these questions, that the different decisions reached in the various courts emphasise the difficulty of applying this provision. At first instance, McGregor J. in the Supreme Court[5] held that the deduction of the total expenditure should not be allowed, and this decision ultimately prevailed in a split decision in the Privy Council,[6] but the Court of Appeal[7] and the minority in the Privy Council[8] took the opposite view.

(1) *Appropriate Test of Deductibility*

On this submission, that the appropriate test of deductibility under s. 111 was whether the expenditure in question was exclusively incurred in producing the assessable income of Europa, the Courts were all in agreement.

McGregor J., citing the two decisions of the Privy Council of *Ward & Co.* v. *Commissioner of Taxes*[9] and *Aspro Ltd.* v. *Commissioner of Taxes*[10] regarded this submission as incontrovertible.[11] The judges of the Court of Appeal took the same view,[12] but they also applied a second test of deductibility, which was whether the gross amount claimed as a deduction was shown by the evidence to have been subject to a discount, the amount of which the Commissioner was entitled to subtract from the deduction claimed.

This was treated as an independent submission, whereas it was advanced by counsel for the Commissioner as a submission on the facts to establish a duality of purpose, primarily in answer to Europa's submission that the Pan Eastern arrangement was a genuine refining venture.

This elevation of a submission on the facts to a separate test of deductibility was not followed by the Privy Council,[13] which it seems

5. [1970] N.Z.L.R. 321, 324.
6. [1971] 2 W.L.R. 55; [1971] N.Z.L.R. 641.
7. [1970] N.Z.L.R. 321, 368.
8. [1971] 2 W.L.R. 55, 67; [1971] N.Z.L.R. 641, 653.
9. [1923] A.C. 145.
10. [1932] A.C. 683.
11. [1970] N.Z.L.R. 321, 341 (line 13).
12. North P. stated this test to be self-evident from the terms in which the section was expressed, p. 383; see also McCarthy J. at p. 427, and Turner J. at p. 395.
13. The majority expressly recognised that the major emphasis had been on this first test in argument, rather than on the factual submission suggesting than an indirect form of discount or concession had been given — see p. 61C; 647.

assumed that the proper test was whether the expenditure had been exclusively incurred in the production of assessable income, and it therefore concerned itself instead with the problems of its application, taking for granted its existence.

(2) *Narrower test than Australia and United Kingdom*

This submission has assumed great significance as a result of the 1968 Amendment, which rendered our s. 111 substantially similar to the Australian and English provisions. If their provisions were indeed wider than our old section, then the amendment may have significantly altered the scope of this deduction provision in New Zealand, and might likewise have changed the result of the *Europa* case had it been decided under the new section.

The equivalent Australian provision reads:[14]

> 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 . . .

In *Kemball* v. *Commissioner of Taxes*,[15] the Court of Appeal said that the English and Australian decisions had no real bearing on the case before the Court, since the language of their provisions was different,[16] which reinforced the submission that the old provision was narrower than the equivalent provisions in Australia and England.

This view was strengthened by the effect which the Australian provision was considered to have in *Amalgamated Zinc (de Bavay's) Ltd.* v. *F.C.T.*[17]

> The expression "in gaining or producing" has the force of "in the course of gaining or producing" and looks rather to the scope of the operations or activities and the relevance thereto of the expenditure than to the purpose in itself.

The suggestion here was that the test of deductibility applied in Australia under s. 51 was wider than our test of purpose, which was accepted as being the test under s. 111 by the Supreme Court and the Court of Appeal.

McGregor J.[18] rightly recognised that our provision was in certain respects narrower than the Australian provision,[19] but whether it was

14. s. 51 (1) Income Tax Act 1936-1968. The English provision, s. 137 (a) Income Tax Act 1952 prohibits deduction of expenses not "wholly and exclusively laid out or expended for the purposes of the trade, profession, or vocation".
15. [1932] N.Z.L.R. 1305, 1307.
16. Also, in *Ward & Co.* v. *C. of T.* [1923] A.C. 145, it was said that the English decisions had no bearing on that case since their language was different.
17. (1935) 54 C.L.R. 295, 309.
18. [1970] N.Z.L.R. 321, 341 (line 13).
19. The Report of the Ross Committee on Taxation Review, in recommending an amended section on the lines of the Australian provision, expressly recognised our section to be more rigid and narrow. Paragraph 476, p. 147.

narrower in those respects which were relevant to its application in this particular case is better left until the test as applied in this case has been examined in more detail. It then becomes relevant to enquire whether the *Europa* decision, if decided under the amended provision, would have been different, which will be done at the conclusion of this discussion.

(3) *Questioning Purpose, But not Wisdom*

It was submitted for the Commissioner that an investigation of the purpose of an expenditure was a separate and distinct inquiry from an investigation into the wisdom of an expenditure, which the Commissioner was precluded from doing by virtue of the principle in *Ronpibon Tin No Liability* v. *F.C.T.*[20]

It was accepted in all the Courts that they were separate enquiries,[21] although Turner J. expressly stated that while excessive expenditure would not alone be conclusive, nonetheless it might justify the inference that an amount had been expended partly for another purpose. Although this question was not considered by the other judges, this approach seems to be the most realistic reconciliation of two principles between which the dividing line may often be unclear.

(4) *Apportionment made Between Dual Purposes*

It was accepted by the courts that the test of deductibility was whether an expenditure had been exclusively incurred in the production of assessable income;[22] the difficulty arose in the manner of application of this test. On this issue, it was submitted that expenditure could be apportioned where it was incurred for two or more purposes, a deduction being allowed in respect only of that part which was exclusively incurred in the production of the assessable income of the taxpayer.

McGregor J.[23] and the Court of Appeal[24] accepted this as the proper test to be adopted, relying on *Aspro Ltd.* v. *Commissioner of Taxation*[25] and, in the Court of Appeal, also on *Littlewoods Mail Order Stores Ltd.* v. *Commissioner of Taxation.*[26] In doing so, both courts rejected the argument for Europa, based on *Cecil Bros. Pty. Ltd.* v.

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20. (1949) 78 C.L.R. 47. This principle was further approved by the High Court of Australia in *Cecil Bros.* v. *F.C.T.* (1964) 111 C.L.R. 430 for which princple his decision was cited by the Privy Council in *Europa,* at p. 63; 649.
21. McGregor J. at p. 343; North P. at p. 386; McCarthy J. at p. 429; Turner J. at p. 400. It was also clearly the view of the majority in the Privy Council, where they approved *Cecil Bros.* (see above) for the second principle, and on the other hand held the Commissioner to be entitled to ascertain for what the expenditure was in reality incurred i.e. purpose; see p. 63; 648.
22. This was the basis of the second submission, already considered.
23. [1970] N.Z.L.R. 321, 344.
24. North P. at pp. 383-4; Turner J. at pp. 395-7; McCarthy J. at p. 428.
25. [1932] A.C. 683.
26. [1969] 1 W.L.R. 1241.

F.C.T.,[27] that business expenditure was not apportionable where trading stock had been purchased.

In this case, the Commissioner had disallowed deductions on the basis that Cecil Bros. had purchased trading stock from the Breckler Ltd., the shareholders in which were close relatives of the owners of Cecil Bros., at a price higher than the same goods were obtainable directly from the manufacturer or wholesaler.

Owen J. in the lower Court held that the fact that the taxpayer had paid more for its purchases than it would have paid had it dealt with the manufacturers or wholesalers, in order that Breckler Pty. Ltd. might make a profit out of the transactions, was not sufficient to warrant disallowance as a deduction. He took the view that to hold otherwise would be to say that the taxpayer had paid more for its goods than it should have, an investigation into wisdom, not purpose.

The High Court agreed with Owen J., and Dixon C.J. said:[28]

> Upon these facts, once it was held that the payment of the amount received by Breckler Pty. Ltd. from the taxpayer company was paid for boots and shoes as stock in trade, there could, I think, be no ground for excluding any part of it from the allowable deductions from assessable income.

Counsel for Europa relied on this statement in contending that, where expenditure was incurred in the purchase of trading stock, as was Europa's expenditure on oil, then the Commissioner's powers extended only as far as determining how much was spent on trading stock. Expenditure on trading stock was of its nature prima facie incurred in the production of assessable income, and the Commissioner could not thereafter question its purpose. This submission was rejected in both the Supreme Court and in the Court of Appeal.

McGregor J.[29] distinguished the *Cecil Bros.* case on its facts, on the ground that there the benefit of the whole price actually paid for goods pursuant to contracts with an outside company went to the outside company. By contrast, in the *Europa* case the concern was not with one agreement with an independent party but with related agreements between vendor and purchaser which provided, not independently but dependent on each other, the concession to the purchaser.

There are two criticisms which can be made of this distinction, both of which depend upon acceptance of the dual purpose test as the proper test. Firstly, applying the purpose test strictly, it would be irrelevant that the purpose was to benefit an independent rather than a related company; the only question would be as to the existence of such a dual purpose.

But even if such a strict application of the test was seen as too

27. (1964) 111 C.L.R. 430.
28. Ibid., p. 438.
29. [1970] N.Z.L.R. 321, 346.

wide,[30] it can nevertheless be argued that Breckler Ltd. was a related company,[31] since its members were close relatives of the members of Cecil Bros., and therefore a direct benefit to Breckler Ltd. was an indirect benefit to Cecil Bros.

These criticisms substantiate the point that *Cecil Bros.* would have best been distinguished not on its facts but on the Australian provision in relation to which it was considered, since that provision was different. The Court of Appeal, like McGregor J., did not refer to this distinction, and instead declined to follow the Australian decision since they considered that it unnecessarily restricted the application of the purpose test.[32]

The majority in the Privy Council appeared to avoid the difficulties raised by the decision in *Cecil Bros.*, citing it as authority in only a minor feature of the case.[33] In their judgment they formulated a modified test of deductibility to be applied in cases such as that before them, where expenditure had been incurred on trading stock. They phrased their test in terms of contractual construction, rather than purpose, while also pointing to two principles to be borne in mind in considering the legitimacy of a deduction claimed.

The first of these was in effect the purpose test, whereby the Crown was not bound by the taxpayer's statement of account, but was entitled to ascertain for what the expenditure was in reality incurred.[34] The second principle was that the Crown could not say what a taxpayer ought to have spent.

Further to these two relevant considerations, they stated that s. 111 did not enable the Crown to disallow expenditure genuinely made whenever it could be found that some economic advantage accrued to the trader as a result of making the expenditure. But the crucial part of their judgment was their formulation of the test to be applied in this type of case, enunciated thus:

> For a claim to disallow a portion of expenditure incurred in purchasing trading stock to succeed, the Crown . . . must show that, as part of the contractual arrangement under which the stock was acquired, some advantage, not identifiable as, or related to the production of assessable income, was gained, so that a part of the expenditure, which can be segregrated and qualified, ought to be considered as consideration given for the advantage. Taxation by end result, or by economic equivalence, is not what the section achieves.[35]

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30. Such a test would entitle disallowance of deductions for any secondary purpose of expenditure, however remote.
31. Indeed, Turner J. refers to Breckler Ltd. as a subsidiary company, see p. 400.
32. See North P. at p. 386; Turner J. at p. 401; McCarthy J. at p. 429.
33. [1971] 2 W.L.R. 55, 63; N.Z.L.R. 641, 649.
34. [1971] 2 W.L.R. 55, 63; N.Z.L.R. 641, 648.
35. [1971] 2 W.L.R. 55, 63; N.Z.L.R. 641, 649.

(5) *Application of Legal Principle to Fact*

McGregor J. in the Supreme Court saw Pan Eastern not as a conventional refining venture but as a passive acceptor of profits, and consequently held that the primary object of the arrangements was to enable Europa to obtain products and later feedstocks at a concession price, thereby avoiding the repercussions or embarrassments of departing from the pattern of posted prices.

This interpretation of the facts can be contrasted with that of the Court of Appeal. North P.[37] regarded the Pan Eastern arrangement as genuinely designed to give Europa a share in the refining sector, and he considered the Commissioner's argument that it was a device broke down since Pan Eastern's profit could have almost wholly disappeared while leaving Europa still obliged to pay posted prices. (On the other hand, the facts clearly showed what action was taken by Europa when Pan Eastern's profits did decline; it then obtained a retrospective guaranteed minimum).

All of the judges in the Court of Appeal[38] attached great significance to Europa's payment of posted prices, and they took the view that a deduction would only be disallowed if it could be shown that supplies could have been obtained elsewhere at lesser prices, but it is submitted that this consideration alone is largely irrelevant. An approach such as this looks at the amount expended in the abstract, seeing the expenditure as for supplies alone, but failing to examine the reality of the transactions.[39] It can be no answer to say they paid the market price, for this does not determine their purpose in paying such a price, nor their real gain from doing so.

McCarthy J. formulated a different basis for his decision, stating[40] that the mere fact that Europa secured for another company in which it held a substantial interest contemporaneous benefits of a very substantial nature was more an incidental consequence than a direct purpose of its expenditure. This echoes the view taken by the minority in the Privy Council, and must depend largely on the interpretation given to the facts. If the indirect benefit is of a very substantial nature, as indeed it was in this case,[41] then it is consequently more likely to be seen as a separate purpose than as a merely incidental consequence. In this case, there was weighty evidence suggesting that the Pan Eastern arrangement was largely a device to obtain a concession, and this evidence proved conclusive in the Privy Council.

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37. [1970] N.Z.L.R. 321, 380.
38. North P., pp. 3801381; Turner J. at p. 402; McCarthy J. at p. 524.
39. This criticism applies also to the separate test applied by Turner J., in adopting the test used in the application of s. 108, Land and Income Tax Act, 1954, namely whether transactions were explicable by reference to ordinary commercial dealing, since he too treated the payment of the market price as conclusive in satisfying this test. See p. 404.
40. p. 429.
41. The effective return to Europa was 30% of its initial outlay, and these returns amounted to approximately half Europa's total profits.

This test is not enunciated in terms of purpose, but instead in terms of the proper construction of the contract, in which a part of the consideration, prima facie expended on trading stock, can be regarded as having been given for the advantage. In the *Cecil Bros.* type case, where the advantage gained by the payer is of an intangible nature, it would not on a proper construction of the contract be seen as an advantage or collateral benefit separate in the contract itself as having been obtained for consideration.

This modified test does not mean the test of purpose applied in the lower courts was abandoned by the Privy Council, for a contract cannot be considered in the abstract. In order to decide whether an advantage is related to the production of the assessable income, the purpose behind the expenditure will necessarily illumine the nature of this relationship. However, it does add to the requirement of a dual purpose a further prerequisite, namely that the advantage was contemplated by the contract as having been procured for separate consideration. It was because expenditure on trading stock was by its nature prima facie deductible that the Privy Council introduced safeguards to limit the wide scope of the purpose test possible in such a context.

The difficulties of the purpose test are seen in respect to incidental advantages and inducements given to attract a taxpayer's business. The Privy Council has to a degree lessened the ease by which such inducements might be quantified and disallowed, since contractual concepts are more narrowly construed than concepts of purpose. It would be unlikely for a collateral advantage to be regarded in the contract as given for separate consideration, unless it was of a substantial nature and could therefore be seen as a significant factor in the contractual agreement.

The majority expressly recognised that not every economic advantage obtained should be disallowed, thereby illustrating their own awareness of the difficulties later elaborated on by the minority,[36] and their approach of confining the purpose test within reasonable limits by concentrating on the contractual nature of the agreements, it is suggested, is preferable to the minority's view, the logical result of which is that no inducement, however large, should be disallowed.

The test posed by the majority has not rendered the question of deductibility for expenditure on trading stock, where a further purpose is evident, substantially easier, but it has qualified the possibly unlimited scope of the purpose test. The question essentially remains one of fact, and it is in the discretion of the court to assess the magnitude of the inducement in order to see whether it constituted a separable purpose of the expenditure and, in addition, whether it was obtained for part of the consideration paid under the initial expenditure for trading stock.

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36. The minority saw difficulty in the quantification of such inducements as extended credit; a promise to hold prices steady for a period; the prospect of a dividend based on purchases if the supplier were a cooperative wholesale society. (Ibid., p. 71, 657.)

THE PRIVY COUNCIL

In the lower courts, the judges in applying the purpose test looked rather to the substance of the transactions than to the form,[42] while the Privy Council expressly restricted its analysis to the contractual nature of the arrangements, and in this respect gave full recognition to the principle in *Duke of Westminster* v. *I.R.C.*[43] It expressed its inability to disregard the separate corporate entities[44] or the nature of the contracts made and to tax Europa on the substantial or economic or business character of what was done.

Their approach was to consider in detail the contractual agreements made, recognising that the words used by the parties could shed only partial light on the agreements. On their construction of the contracts, the majority Law Lords held that there was a single interrelated complex of agreements under which Europa was seen as having incurred expenditure for a compound consideration, consisting partly of gasoline to be supplied and partly of advantages to be derived through Pan Eastern.

The minority's construction of the contracts was considerably narrower,[45] yet their difference of opinion with the majority on this point was largely one of fact, not of principle. While the majority saw each contract not as isolated but as part of an interrelated group which had to be considered together, the minority regarded the supply contract as independent of the other contemporaneous agreements made, and therefore considered the expenditure made thereunder could not be disallowed.

CONCLUSION

The Privy Council[46] effectively qualified the dual purpose test applied in the lower Courts, since their Lordships phrased their test in contractual terms, thereby limiting the number of cases where deductions could be disallowed, but it must be remembered that their test is limited to cases where the expenditure was for trading stock. The question therefore arises as to whether the Privy Council's decision is still of any relevance, since section 111 has since been amended.

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42. McGregor J. seemed to regard the form of the transaction as not conclusive as to its nature, preferring an examination of the substance of the transactions, for which he relied on *I.R.C.* v. *Wright* [1927] 1 K.B. 333, and *Secretary of State in Council of India* v. *Scoble* [1903] A.C. 299; see judgment at p. 340. See also North P. at p. 379; Turner J. at p. 404; McCarthy J., p. 422.
43. [1936] A.C. 1. The principle enunciated in that case was that the legal effect of the contract as it stands must be ascertained and not what might be the legal effect if the words of the contract were disregarded and the substance of the matter considered.
44. A view also taken by the judges in the Court of Appeal.
45. [1971] 2 W.L.R. 55, 68H; N.Z.L.R. 641, 654.
46. This includes both the majority and the minority.

The new provision[47] reads as follows:

> In calculating the assessable icome of any taxpayer, any expenditure or loss to the extent to which it —
>
> (a) is incurred in gaining or producing the assessable income for any income year; or
>
> (b) is necessarily incurred in carrying on a business for the purpose of gaining or producing the assessable income for any income year —
>
> may, except as otherwise provided in this Act, be deducted from the total income derived by the taxpayer in the income year in which the expenditure or loss is incurred.

This provision is substantially the same as the Australian provision considered in *Amalgamated Zinz (de Bavay's) Ltd.* v. *F.C.T.*[48] where it was said that one was concerned more with the scope of the operations or activities and the relevance thereto of the expenditure than with the purpose itself.

A similar approach has been taken in New Zealand under the new section, for in *Tout* v. *Inland Revenue Commissioner*,[49] the test applied was whether the expenditure sought to be deducted was relevant and incidental to the gaining of the taxpayer's assessable income,[50] which was expressly taken from the Australian authorities.

The effect of the amendment has undoubtedly been to broaden the scope of s. 111,[51] for subs. (b) allows as a deduction any expenditure provided it is in some way related to the carrying on of the business, as distinct from the previous requirement that it be directly related to the production of assessable income.

However, it is submitted that, because the object of the amendment was primarily to provide greater flexibility in the legitimate objects of a business expenditure which may be deducted, the decision in the *Europa* case has in no way been substantially undermined by the amended provision. The amendment does not assist in the *Europa* type case where the objects of the expenditure are uncertain. The issue here is whether there has in fact been more than one object in the expenditure, and it is only after the real objects have been diagnosed that the section as amended becomes important.

Therefore, the approach of the courts where an expenditure is made for trading stock, but which allegedly serves a further purpose, will be regulated by the *Europa* case. If the purpose test were still in vogue, then certain purposes where regarded as a separate object of

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47. Section 12, Land and Income Tax Amendment Act, 1968.
48. (1935) 54 C.L.R. 295, 309.
49. (1970) 1 A.T.R. 705.
50. Beattie J., in *Castle* v. *C.I.R.* (1971) (unreported), took the same approach.
51. The recommendations of the Ross Committee on Taxation that this new provision replace the old provision makes this clear; see Report, pp. 196-197.

the expenditure might be allowable under the wider provision, but since the purpose test has been modified, it is doubtful whether such a purpose would often stand up as a separate object of the expenditure.[52]

It would now seem that expenditure on trading stock is prima facie allowable, unless on a proper construction of the contracts, a further advantage can be regarded as having been obtained for part of the consideration. Applying themselves to the *Europa case,* the interdependence of the contractual agreements led their Lordships in the Privy Council to conclude that the return through Pan Eastern giving an indirect price discount was an integral part of all the contracts considered as a whole, and they disallowed the deductions claimed accordingly.

The majority in the Privy Council have therefore formulated a test to be applied where an expenditure on trading stock is accompanied by a collateral advantage, and the effect of this test has been to confine the scope of the purpose test. The question of purpose is still a relevant consideration, but its significance is qualified by the requirement that the advantage obtained must, on a proper construction of the contract, be seen as obtained for separate consideration.

The consequence of the *Europa* decision has therefore been to restrict further the Commissioner's powers of disallowance. Accompanied as it is by the amended provision which similarly weakens the Commissioner's powers, the cumulative effect of these recent developments has in fact been to extend the utility of s. 111, although Europa Oil (N.Z.) Ltd. may be loathe to agree on this point.

L. J. W. LUDBROOK.

s a result, it would seem that the *Cecil Bros.* case is perfectly reconcilable ith *Europa,* since the purpose served there, being of an intangible nature uld not be seen by the court as having been recognised by the parties part of the contractual agreement.