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THE MEANING OF "INCURRED": PERSUASIVE AUTHORITY FROM DOWNUNDER

The term "incurred" plays a fundamental role in the operation of the deduction provision in section 14(1) of the Income Tax Act. However, its meaning has yet to be judicially examined in any depth by the Singaporean courts. There is, however, a significant body of Australian jurisprudence on the meaning of this expression. This article examines the Australian pronouncements on this concept and comments on their potential persuasive value in Singapore.

I. Introduction

THERE are both similarities and differences between the Australian "general deduction provision" (contained in section 8-1 of the Income Tax Assessment Act 1997) and its Singaporean "equivalent" (contained in section 14(1) of the Income Tax Act, Cap 134, 1999 Rev Ed). A common feature of the provisions is that they both require outgoings to be "incurred" as a prerequisite for deductibility.[1] The Australian common law is peppered with many judicial observations on the meaning of this term. Its importance in Australia is highlighted by the number of High Court judgments that have considered it and its continued relevance is demonstrated by the fact that cases continue to creep before the courts on this issue. By way of comparison, so far, there have been no significant Singaporean decisions on the meaning of this expression.

The purpose of this article is to review and analyse the development of the Australian common law on the meaning of the term "incurred" and to examine its role in the operation of the Australian general deduction provision. In concluding, this article briefly discusses the potential relevance that the Australian jurisprudence might have in relation to the interpretation of the Singaporean deduction provision.

[1] This requirement also exists under the general deduction provisions in the tax statutes of a number of other jurisdictions such as Malaysia, New Zealand, Hong Kong and South Africa.

II. The Deduction Provisions

Section 8-1 of the Income Tax Assessment Act 1997 was introduced as part of the Tax Law Improvement Project's rewrite of the tax laws and has operated in Australia since 1 July 1997. It replaced section 51(1) of the Income Tax Assessment Act 1936 which had certainly become one of the most litigated provision in Australia's income tax laws.[2] The new provision essentially retains most of the wording of its predecessor and is only different from a drafting style perspective. The Explanatory Memorandum accompanying the Bill that introduced the rewritten provision expressly indicated that the introduction of the new provision would not operate to effect any change in the law.[3] This means that the extensive body of existing common law dealing with section 51(1) is directly relevant to the interpretation of section 8-1.

Section 8-1 contains both positive and negative "limbs". The positive limbs of the provision are contained in sub-section (1) which provides:

> You can deduct from your assessable income any loss or outgoing to the extent that:
>
> (a) it is incurred in gaining or producing your assessable income; or
>
> (b) it is necessarily incurred in carrying on a business for the purpose of gaining or producing your assessable income.

The negative limbs of the provision are contained in sub-section (2) which denies deductions to the extent that the relevant losses or outgoings are of a "capital" or "private or domestic" nature or are incurred in relation to gaining exempt income. It also denies deductions for losses and outgoings that the Act prevents from being deductible.[4]

In comparison, section 14(1) of the *Income Tax Act* provides:

2 In commenting on the provision one commentator remarked: "It is amazing that a provision couched in such simple terms ... has given rise to so much jurisprudence.": IV Gzell QC, "Allowable Deductions: The *Coles Myer* and *Fletcher* Decisions" (1993) 28 Taxation in Australia 275.

3 "The Bill rewrites subsection 51(1) with a clearer structure but does not disturb its language and is not intended to effect previous interpretations": Explanatory Memorandum to the Income Tax Assessment Bill 1996 at 44.

4 For a general discussion of the operation of s 8-1 see Woellner, Barkoczy and Murphy *et al*, *Australian Taxation Law,* (10th ed, 2000) at 670-773.

> For the purpose of ascertaining the income of any person for any period from any source chargeable with tax under this Act (referred to in this Part as the income), there shall be deducted all outgoings and expenses wholly and exclusively incurred during that period by that person in the production of the income ...

The provision goes on to include specific categories of outgoings and expenses which fall within its domain. The Singapore "broad equivalent" of section 8-1(2) is found in section 15 of the *Income Tax Act* which lists several specific kinds of outgoings and expenses that are not deductible.

III. The Australian Jurisprudence

A. *Relevance of Payment*

At the outset, it is important to note that the Australian and Singaporean legislatures have chosen to use the word "incurred" rather than "paid" in their respective deduction provisions. The significance of the use of this language has been noted in early Australian High Court authority dealing with former section 23(1)(a) of the Income Tax Assessment Act 1922 which used the expression "actually incurred". In *W Nevill & Co Ltd* v *FC of T*,[5] Latham CJ (Rich, Dixon and McTiernan JJ concurring) observed that:

> ... [T]he word used is "incurred" and not "made" or "paid". The language lends colour to the suggestion that, if a liability to pay money as an outgoing comes into existence, the quoted words of the section are satisfied even though the liability has not been actually discharged at the relevant time. The word 'actually' is not inconsistent with this view. It is only the incurring of the outgoing that must be actual; the section does not say in terms that there must be an actual outgoing – a payment out.[6]

The fact that payment is not required for a liability to be incurred has been illustrated in many Australian court decisions concerning former section 51(1) of the Income Tax Assessment Act 1936. These include cases involving financing costs (*Alliance Holdings Ltd* v *FC of T,*[7] *FC of T* v *Australian*

[5] (1937) 56 CLR 290.
[6] *Ibid,* at 302.
[7] 81 ATC 4637.

Guarantee Corporation Ltd[8] and *Coles Myer Finance Ltd* v *FC of T)*[9] and cases involving provisions made by insurers for unreported insurance claims (*RACV Insurance Pty Ltd* v *FC of T,*[10] *Commercial Union Assurance Co of Australia Ltd* v *FC of T*[11] and *FC of T* v *MMI (Workers Compensation) Ltd & Anor*).[12] The view that a disbursement is not required for a liability to be incurred has also been accepted in other jurisdictions (see, for example, *C of IR (HK)* v *Lo & Lo*)[13] and would therefore appear to be well settled and broadly accepted.

Whilst the above authorities make it clear that payment is not a prerequisite for deductibility, there is also authority that indicates that payment can operate to crystallise a liability. For instance, in *FC of T* v *Lau*[14] deductions were allowed in the year of payment for amounts paid for future years' management fees relating to a forest plantation scheme.[15] Likewise, in *FC of T* v *Raymor (NSW) Pty Ltd*[16] expenditure on trading stock in the year before it was delivered was held to be deductible notwithstanding that the cost of the trading stock could be retrospectively adjusted to take into account price fluctuations in the following year. Not surprisingly, the Australian legislature has frowned upon these kinds of pre-payment arrangements and has tackled them by introducing specific statutory rules such as the "pre-payment rule"[17]

8 84 ATC 4642.
9 (1993) 176 CLR 640.
10 74 ATC 4169.
11 77 ATC 4186.
12 99 ATC 4404.
13 [1984] WLR 986.
14 84 ATC 4929.
15 Compare *Merchant* v *FC of T* 99 ATC 4221 (discussed below) which also concerned, *inter alia,* management fees but which did not involve a pre-payment.
16 90 ATC 4461.
17 This rule is contained in sections 82KZL to 82KZO of the Income Tax Assessment Act 1936. Originally, the rule applied to expenditure (other than "excluded expenditure") incurred under an agreement entered into after 25 May 1988 which was otherwise deductible in the year the expenditure was incurred where the expenditure was incurred in return for the doing of a thing under the agreement that was "not to be wholly done within 13 months after the day on which it was incurred". The rule required such expenditure to be deductible over the lesser of 10 years or the "eligible service period". As a result of recommendations made by the Review of Business Taxation in its report titled *A Tax System Redesigned* (July 1999), the Government has modified and tightened the pre-payment rule. Very broadly, taxpayers who are not classified as "small business taxpayers" that incur expenditure after 11.45 am on 21 September 1999 are no longer be entitled to an immediate deduction for expenditure relating to things done within 13 months. Subject to transitional rules, these taxpayers are required to deduct the expenditure over the period the relevant thing is to be done. In addition, under a separate measure, taxpayers who incur expenditure after 1 pm on 11 November 1999 in respect of "tax shelter" type arrangements are required to spread the deduction over the period the relevant services are provided.

and "stock on hand rule"[18] which operate to remove the timing benefit otherwise available.[19]

B. *Sufficient Level of Commitment*

It is evident from the above quoted passage from *Nevill* that in determining whether or not a loss or outgoing has been incurred, the courts focus on the existence of a liability rather than whether or not it has been discharged. What the courts are really doing is examining whether or not the taxpayer is sufficiently committed to the liability. Therefore, the key issue involves establishing what level of commitment is required. Must, for instance, a taxpayer be legally committed to a liability for it to be incurred? Or, is some lesser form of commitment sufficient and, if so, what degree of commitment is required? Also, must the liability be indefeasible for it to be incurred?

The courts have expressed what is required in a variety of colourful ways. In one of the leading cases, *FC of T* v *James Flood Pty Ltd,*[20] the High Court indicated that to have incurred a loss or outgoing, the taxpayer must have "completely subjected himself" to the loss or outgoing. *James Flood* concerned the deductibility of an amount set aside by an employer to meet its anticipated future holiday pay obligations. The relevant award provided that the taxpayer's employees were only entitled to receive holiday pay after 12 months continuous service. An employee's entitlement to holiday pay could be lost in certain circumstances such as where the employee was involved in an unauthorised strike or absenteeism, or died. The High Court held that the taxpayer was not entitled to deductions for the amount it had set aside to meet the holiday pay of those employees who had not yet completed the 12 months service period at the end of the relevant year as no liability to make holiday payments had been "incurred" at such time. According to the Court, the taxpayer simply faced the possibility that it might have to incur a loss or outgoing in the future. In a frequently cited passage, Dixon CJ, Webb, Fullagar, Kitto and Taylor JJ indicated that under section 51(1) no deduction is available:

[18] Under this rule which is now contained in section 70-15 of the *Income Tax Assessment Act 1997,* a taxpayer is not entitled to a deduction for outgoings incurred in acquiring trading stock until the trading stock becomes "trading stock on hand". This provision is the rewrite of former section 51(2A) of the Income Tax Assessment Act 1936. The former provision applied to outgoings incurred between 19 December 1991 and 1 July 1997 whilst s 70-15 applies to outgoings incurred on or after 1 July 1997.

[19] See further, Woellner, Barkoczy and Murphy *et al, supra,* note 4, at 928-931 and 948-949 and CCH *2000 Australian Master Tax Guide* (31st ed, 2000), at 348, 705 and 708-710.

[20] (1953) 88 CLR 492.

> ...[U]nless, in the course of gaining or producing the assessable income or carrying on the business, the taxpayer has completely subjected himself to them. It may be going too far to say that he must have come under an immediate obligation enforceable at law whether payable presently or at a future time. It is probably going too far to say that the obligation must be indefeasible. But it is certainly true that it is not a matter depending upon "proper commercial and accountancy practice rather than jurisprudence."[21]

The above passage was examined closely by the High Court in *Nilsen Development Laboratories Pty Ltd* v *FC of T*[22] which also concerned provisions that a taxpayer had made for its employees' leave. The taxpayer was unsuccessful in arguing that *James Flood* should be distinguished on the basis that different facts were involved since the relevant awards in the latter case entitled the taxpayer's employees to periods of leave proportionate to their period of service and were not subject to any qualifying period. The High Court held that it was only when an employee took leave that an accrued liability to pay arose and an outgoing would be incurred. The High Court found that even though the leave entitlements were indefeasible and would inevitably need to be met by the taxpayer at some stage, the taxpayer was not under any obligations to make the payments until its employees actually took leave. In other words, although it was certain that a liability to make leave payments would arise in the future, such a liability had not been crystallised at the relevant time. Gibbs J (as he then was) explained this as follows:

> The entitlement to payment would not arise until the employees took leave (or died or left the employment). The event on which the entitlement of the employees to payment depended had not occurred. There was a certainty that a liability to make payments in respect of leave would arise in the future, but it had not arisen. The present is not a case in which there was an immediate obligation to make payment in the future, or a defeasible obligation to pay, or a present obligation which as a matter of law was unenforceable – there was no accrued obligation to make payment at all.[23]

[21] *Ibid,* at 506.
[22] (1981) 144 CLR 616.
[23] *Ibid,* at 627-628.

Barwick CJ expressed the matter in slightly different terms. He indicated that a loss or outgoing must "come home"[24] to the taxpayer for it to be incurred. In the course of his judgment, the Chief Justice examined the above quoted passage from *James Flood* and explained that it required there to be a "presently existing liability"[25] for a loss or outgoing to be incurred. The "presently existing liability" concept has become a well entrenched yardstick in Australian jurisprudence for determining whether a loss or outgoing has been incurred and the test has been applied in many cases handed down since *Nilsen.*[26]

Nilsen therefore illustrates that no matter how certain it is that a loss or outgoing will arise in the future, in order for the loss or outgoing to be treated as having been incurred at a relevant point in time, it must have crystallised at such time. In other words, it must have "accrued" or "come home" to the taxpayer so as to create a "presently existing liability". This point is vividly illustrated in *Ogilvy & Mather Pty Ltd* v *FC of T.*[27] In that case, the Full Federal Court denied an advertising agency deductions for advertisements placed with various media outlets which had not been paid for but which nevertheless had passed various "non-cancellation" periods. Sweeney and Ryan JJ explained how they reached this conclusion based on the facts:

> ... [T]he correct analysis of the contracts between Ogilvy & Mather and the media proprietors or publishers is that a liability did not attach to Ogilvy & Mather until the relevant advertisement had been published or the time or space had been made available for its publication on the agreed date. The effect of the commencement of a "non-cancellation period" was to preclude Ogilvy & Mather from unilaterally avoiding the obligation to pay for the advertisement. However, that is not to say that the liability was incurred, in the sense that Ogilvy & Mather was "definitively committed" to discharge it, from the moment when the non-cancellation period commenced. ... it was publication of the advertisement which definitively committed the agency to the liability, even though payment was not due ... until the thirtieth day of the month following that in which the advertising was published, broadcast or telecast. In the language used in *FC of T* v *James Flood Pty Ltd* ...

[24] *Ibid,* at 624.
[25] *Ibid,* at 627.
[26] See, for example, *Merchant, supra*, note 15, *MMI, supra,* note 12, *Australia and New Zealand Banking Group Ltd* v *FC of T* 94 ATC 4026, *Coles Myer, supra,* note 9 and *Ogilvy & Mather Pty Ltd* v *FC of T* 90 ATC 4836.
[27] 90 ATC 4836.

> it was not until publication that there arose a debitum in praesenti, solvendum in futuro ...[28]

Whilst the Courts in *Nilsen* and *Ogilvy & Mather* adopted a strict approach to determining when a liability crystallises, one should be cautious in reading too much into the judgments. It is important to note that the courts did not reject the obiter in *James Flood* where it was stated that it may be going to far to require a taxpayer to "have come under an immediate obligation enforceable at law whether payable presently or at a future time."[29] Furthermore, there is nothing in the cases which challenges the obiter in *James Flood* that a loss or outgoing need not be indefeasible to be incurred. This seems sensible given the dicta of Newton J in *Commonwealth Aluminium Corp Ltd* v *FC of T,*[30] where his Honour observed that "all, or almost all, unpaid liabilities are in a sense defeasible, because they could in the future be forgiven by the creditor, or cancelled by Act of Parliament, or barred by any applicable statute of limitations."[31] To preclude a deduction for a liability until such time as it becomes indefeasible would, it is submitted, significantly distort matters since it would ignore the fact that commercially a taxpayer may have already completely subjected himself to the liability.[32]

C. *Impending Threatened or Expected Liabilities*

The Courts in *James Flood, Nilsen,* and *Ogilvy & Mather* repeated what has become one of the most well-known passages on the meaning of the term "incurred" emanating from the early High Court decision in *New Zealand Flax Investments Ltd* v *FC of T.*[33] In that case, Dixon J (as he then was), stated:

[28] *Ibid,* at 4844-4845.
[29] *Supra,* note 20, at 506.
[30] 77 ATC 4151.
[31] *Ibid,* at 4161. His Honour went on to indicate that "If in one year of income a defeasible liability is allowed as a deduction under sec 51, and in a later year the defeasance occurs, so that the liability is divested or destroyed, then it would appear that the amount of the liability will be included in the assessable income of the taxpayer for that later year, provided that the amount can properly be characterised as assessable income of that year, although not simply because it had been allowed as a deduction in the earlier year."
[32] See further *Commercial Union Assurance Co of Australia Ltd* v *FC of T, supra,* note 11, (discussed below).
[33] (1938) 61 CLR 179.

> "Incurred" does not mean only defrayed, discharged, or borne, but rather it includes encountered, run into, or fallen upon. It is unsafe to attempt exhaustive definitions of a conception intended to have such a various or multifarious application. But it does not include a loss or expenditure which is no more than impending, threatened, or expected.[34]

It is apparent from the above that a liability will not be taken to be presently existing where it is merely a possibility in the sense that it is simply "impending threatened or expected". The question of whether a liability has come home to a taxpayer or is merely "impending threatened or expected" at a particular time has divided the courts on occasions. An example of this is found in *Hooker Rex Pty Ltd* v *FC of T.*[35] This case concerned a land development company which had acquired shares in another company and liquidated its subsidiaries so as to transfer the land to itself. The Commissioner had assessed the subsidiaries to tax in respect of the 1973 year on the basis that the land constituted trading stock and that the transfer attracted the operation of former section 36 of the Income Tax Assessment Act 1936. The Commissioner agreed, however, to defer payment of the outstanding tax pending the resolution of separate litigation which was concerned with the issue as to whether land could constitute trading stock. In the meantime, the taxpayer had entered into guarantees with the Commissioner undertaking to pay any outstanding tax in respect of the liquidated companies. The matter was finally resolved in 1978 when the High Court handed down its decision in *FC of T* v *St Huberts Island Pty Ltd*[36] indicating that land could constitute trading stock. Accordingly, in that year, the taxpayer paid the amounts owing under the guarantees to the Commissioner. A majority of the Full Federal Court held that the relevant liability had been incurred in the 1978 year. Sweeney and Gummow JJ stated that "in 1973 the loss or expenditure of the taxpayer pursuant to the undertakings to the Commissioner was but threatened or contingent." In contrast, Neaves J in his dissenting judgment concluded that the liability had come home to the taxpayer in the 1973 year even though the Commissioner did not insist that it be discharged in such year. The conflicting judgments demonstrate the conundrum faced by the judiciary in ascertaining the point in time at which a liability crystallises.

[34] *Ibid,* at 207. The significance of the last sentence of this passage is highlighted by Barwick CJ's comments in *Nilsen, supra*, note 22, at 624 where he stated, after citing the passage: "and I would for myself add 'no matter how certain it is in the year of income that that loss or expenditure will occur in the future.'"

[35] 88 ATC 4392.

[36] (1978) 138 CLR 210.

A clearer illustration of a liability that was a mere "possibility" and which therefore had not been incurred is found in *Emu Bay Railway Co Ltd* v *FC of T*.[37] This case involved a company that had issued debenture stock. Under the relevant trust deed, interest at 5% per annum was payable on the relevant stock and "was a charge upon and payable *only* out of" the taxpayer's annual net income. The deed went on to provide that the interest was to be payable half-yearly and constituted a cumulative liability from year to year. Although the taxpayer had made a loss in the 1939 year, it nevertheless sought a deduction for an amount equal to 5% of its issued debenture stock for that year. A majority of the High Court[38] held that no liability had come into existence during the relevant year since the company did not have any net income during the year. Latham CJ explained this conclusion as follows:

> As there has never been any such net income, the interest which the company claims is allowable as a deduction did not become payable, has not become a debt, and may never become a debt. ... As things stand at present, the interest has not become payable, and all that can be said is that there exists at the present time the possibility of a liability accruing in the future, such possibility depending, not only upon the derivation of net income, but also on the amount of such income derived.[39]

D. *Referability*

The outcome in *Emu Bay* is not surprising given the terms of the trust deed. The decision can be contrasted with the earlier decision in *New Zealand Flax.* In that case the High Court allowed a company deductions for so much of the interest relating to bonds it had issued that was "referable" to the year in question. The difference in the outcome of the cases can be explained by reference to the fact that in *Emu Bay* the liability was contingent on there being "annual net income" available whereas in *New Zealand Flax,* the company owed "a definite liability" to its bondholders.

The "referability" concept established in *New Zealand Flax* has been adopted in a number of subsequent cases concerning section 51(1) of the Income Tax Assessment Act 1936. For instance, in *FC of T* v *Australian Guarantee Corporation Ltd,*[40] the Full Federal Court allowed a finance

[37] (1944) 71 CLR 596.
[38] Latham CJ, Starke and McTiernan JJ (Rich and Williams JJ dissenting).
[39] (1944) 71 CLR 596, at 606.
[40] *Supra,* note 8.

company deductions for accrued interest on debentures which it had issued notwithstanding that no interest was payable until redemption (which would generally only occur 20 years from the issue date). The Court identified an "ordinary rule that interest accrues due on a daily basis, even if payment is deferred to a future date."[41]

In arriving at its conclusion, the Court in *Australian Guarantee Corporation* had followed the earlier New South Wales Supreme Court decision in *Alliance Holdings Ltd* v *FC of T*[42] which also concerned a finance company. The taxpayer had borrowed money from the public secured by deferred interest debenture stock. Under the arrangement, no interest was payable until the debenture stock matured. Woodward J found that a present obligation to repay the interest to the stockholder came into existence at the time the contract was made notwithstanding that the interest was payable some time in the future. His Honour held that "the contract was one to pay interest which accrued from day to day"[43] and that the liability should be deductible accordingly.

1. *Coles Myer*

It was not until 1993, in *Coles Myer Finance Ltd* v *FC of T,*[44] that the High Court had the opportunity to fully consider the referability concept in the context of section 51(1). The case concerned a corporate group's finance company that had drawn and sold bills of exchange and promissory notes. Some of the bills and notes drawn in the income year ending 30 June 1984 matured in the following year. The major issue before the High Court was whether the taxpayer was entitled to claim deductions for the discounts in respect of these bills and notes in the income year ending 30 June 1984, in the year of income ending 30 June 1985, or over both of these years.

A majority of the High Court[45] held that the discounts were deductible over both of these years.[46] The leading judgment in the case is the joint judgment of Mason CJ, Brennan, Dawson, Toohey and Gaudron JJ. Their Honours found that a "presently existing liability" to pay the face value of the bills and notes on maturity had been incurred at the time the bills and notes were drawn. Nevertheless, they also found that this liability was

[41] *Per* Beaumont J, *ibid,* at 4660.
[42] *Supra,* note 7.
[43] *Ibid,* at 4643.
[44] *Supra,* note 9.
[45] Mason CJ, Brennan, Dawson, Toohey, Gaudron and Deane JJ.
[46] McHugh J, dissenting, held that the discounts were fully deductible in the income year ending 30 June 1984.

"properly referable" to both the income years ending 30 June 1984 and 30 June 1985. Accordingly, their Honours held that the discounts should be deductible on a straight line basis over both these years. Their Honours justified their conclusion on the basis that allowing a deduction for the discounts wholly in the year the bills and notes were drawn would have produced distortions and they were comforted by the fact that their approach accorded with accounting practice.

The case illustrates that the answer to determining when a loss or outgoing is deductible is not simply resolved by identifying when a loss or outgoing has been incurred, but also by reference to a test of referability. This is evident from the following passage from the joint judgment:

> The acceptance by this court of the jurisprudential analysis of section 51 does not compel the conclusion that, once a taxpayer subjects itself in the year of income on revenue account to a present legal liability to pay in a future year of income an amount which generates, or gives rise to, a net loss or outgoing, the net loss or outgoing is deductible in full in the year of income. The relevance of the present existence of a legal liability on the part of the taxpayer to meet the bills and notes at a future date is that it establishes that the taxpayer has "incurred", in the year of income an obligation to pay an amount which gives rise to a net loss or outgoing, being the recurrent cost of acquiring working or circulating capital. But there remains the question: "how much of that net loss or outgoing is referable to the year of income?"[47]

The joint judgment therefore sanctions the adoption of a "two step approach" in determining when an outgoing is deductible. The first step involves an application of jurisprudential principles whereas the second step is concerned with the common sense or practical question of referability. In applying the referability principle, which has also been commonly referred to as the "matching principle", their Honours stated in a subsequent passage:

> In ascertaining what is the taxpayer's net income or profit for a particular year of income, it is proper to set against the taxpayer's gross income or profit for that period the net losses or outgoings referable to that period. Under section 51(1), a loss or outgoing is a deduction only to the extent to which it is incurred in gaining or producing the assessable income. That provision has been described as: "a statutory recognition and application of the accountancy principle which all the accountants who gave evidence referred to as the matching principle" to use the

[47] *Supra,* note 9, at 665.

> words of Menhenitt J in *RACV Insurance Pty Ltd* v *FC of T* 74 ATC 4169, at p 4182; [1975] VR 1, at p 14. Apportionment of the cost over two years of income therefore accords with both accounting principle and practice and the statutory prescription.[48]

2. *Analysis and Application of Coles Myer*

The Coles Myer Finance case sparked much academic debate.[49] In one article on the subject, a prominent Queen's Counsel took the view that the referability test was "revolutionary" and he argued that:

> The Court has added to the statutory requirements of deductibility an additional requirement not found in sub-sec 51(1), namely that the loss or outgoing "be properly referable to the year of income in question". The only statutory requirement is that the loss or outgoing be incurred in the year of income. The requirement that it be "properly referable" to the year of income is simply not found in the legislation.[50]

With respect, it is submitted that the outcome of the case is unremarkable and should not have come as a surprise given the earlier authorities in *New Zealand Flax, Alliance Holdings* and *Australian Guarantee Corporation.* It is arguable that the requirement that a loss or outgoing be properly referable to the year of income is sanctioned by the use of the words "to the extent that"[51] in the general deduction provision.[52] Whilst these words have usually been applied to apportion losses or outgoings by reference to their income producing and non-income producing application,[53] the words can equally be used to support the "temporal apportionment" of a loss or outgoing.

It is apparent that the *New Zealand Flax, Alliance Holdings, Australian Guarantee* and *Coles Mye*r cases share a common feature in that they all

[48] *Ibid,* at 665-666.

[49] See *eg,* S Barkoczy and N Bellamy, "Losses and Outgoings: The 'Matching Principle' — A Heavier Burden?" (1994) 2 Taxation in Australia (Red Edition) 151; M Boesenger and A Helm, *"Coles Myer*: New Directions in the Interpretation of Section 51(1)" (1993) 5(3) The CCH Journal of Australian Taxation 4; and D Murdoch, "Allowable Deductions and Tax Deferral: *Coles Myer Finance Ltd* v *FCT*" (1994) 16 Sydney Law Review 545.

[50] A Myers QC, "Tax Accounting Principles After Coles Myer Finance" *Taxation Institute of Australia Convention Papers,* 32nd Victorian Convention, October 1993, 10.

[51] The Income Tax Assessment Act 1936 used the equivalent phrase "to the extent to which".

[52] S Barkoczy and N Bellamy, "The Woolcombers Decisions: A Sensible Interpretation of the *Coles Myer Finance* Decision" (1994) 6(5) The CCH Journal of Australian Taxation, 16 at 18 and 19.

[53] See *Ronpibon Tin NL* v *FC of T* (1949) 78 CLR 47.

concerned financing costs. This raises the issue as to whether "matching" is confined to this kind of case alone or whether it is of broader application. The issue was examined in *FC of T* v *Woolcombers Pty Ltd.*[54] This case concerned a wool trader that entered into forward contracts for the purchase of its trading stock from woolgrowers. Contracts were entered into up to nine months before shearing and provided that property in the wool passed to the taxpayer upon payment for the wool, which was to occur 14 days after delivery. The Federal Court[55] allowed the taxpayer a deduction in the 1987/88 income year for its estimated liability under the forward contracts made during that year even though none of the wool that had been purchased was sold in that year.[56]

Lee J distinguished *Coles Myer Finance* on the basis that an outgoing incurred in acquiring trading stock could not be readily equated with a loss incurred by a financier involved in a moneylending business.[57] Lee J was of the view that accounting concepts may assist but are not determinative of when a loss or outgoing is deductible. According to his Honour, the relevance of accounting concepts depended on the facts of a particular case. Lee J used a "common sense" approach to resolving the referability issue. In this respect, he stated:

> ... [T]he need for the loss or outgoing to be "properly referable" or "properly attributable" to the income year in which it is sought to be deducted requires the loss or outgoing not to be so anomalous to the revenue operations of the taxpayer as to affect a distortion in the result of those operations in the relevant income year.[58]

[54] 93 ATC 5170.

[55] 93 ATC 4342.

[56] The facts of this case preceded the introduction of s 51(2A) of the Income Tax Assessment Act 1936: *supra,* note 18.

[57] This distinction has been criticised in the following terms: "If his Honour meant to say that there is a difference between a business acquiring trading stock and a financier obtaining circulating capital, it is a distinction without much substance. The circulating capital of a financier performs the same role as the trading stock of a businessman": I Gzell QC, "Allowable Deductions: The Coles Myer and Fletcher Decisions" (1993) 28 Taxation in Australia 275 at 278. Note, however, that Lee J had emphasised that the outgoing remained constant from when it was incurred. "This is in sharp contrast to the finding of the joint judges in *Coles Myer Finance* who were influenced by the fact that the burden of the liability incurred by the taxpayer in that case increased with the passage of time between the discounting of the note or bill and its maturity.": S Barkoczy and N Bellamy, "The Woolcombers Decisions: A Sensible Interpretation of the *Coles Myer Finance* Decision" (1994) 6(5) The CCH Journal of Australian Taxation, 16 at 21.

[58] *Supra*, note 55, at 4349.

Ultimately, his Honour found that the outgoing claimed was not so anomalous as to effect a distortion of the taxpayer's revenue operations in the 1987/88 income year and was therefore properly deductible in full in that year.[59] The Full Federal Court upheld this decision. Beaumont, French and Foster JJ distinguished the finance cases on the following basis:

> In *Coles Myer*, because of the special nature of the financing transaction, it was held ... that apportionment was appropriate. Likewise, in the financial arrangements considered in *Australian Guarantee,* apportionment of the total sum of the interest was proper. But there are no similar features in the present matter, which concerns a relatively simple forward contract for sale without any financing aspect; no question arises here of a liability accruing daily, as interest does, or otherwise accruing periodically.[60]

Woolcombers seems to support the existence of a general principle that outgoings will be referable to the year in which they are incurred and therefore deductible in that year unless this produces "distortions". It is evident from *New Zealand Flax, Alliance Holdings, Australian Guarantee* and *Coles Myer* that distortions arise where financing costs are involved and therefore in such cases "temporal apportionment" is warranted. However, to reconcile these cases with *FC of T* v *Lau,*[61] it is necessary to distinguish between "pre-paid" and "post-paid" expenditure. *Lau* demonstrates that, subject to the operation of the statutory pre-payment rule,[62] pre-paid financing costs are deductible fully in the year that they are incurred.

The practical confinement of the "matching principle" to post-paid financing costs is a neat way of reconciling the law. However, unfortunately, the position may not be so clear given the recent decision in *Merchant* v *FC of T.*[63] In that case, the Federal Court held that only a percentage of rent and management fees relating to a pine tree plantation arrangement were deductible in the year that they were incurred. According to Nicholson J, the proper amount of rent and management fees referable to, and deductible in, the relevant year was the percentage ascertained by reference to the number of days for which the obligation existed in the year of income applied to the total time period of the obligation. Thus, the Court applied the matching principle to outgoings that were not financing costs.

59 The Australian Taxation Office is of the opinion that Lee J's view is inconsistent with the High Court decision in *Coles Myer*: see *Taxation Ruling* TR 94/26 at paras 25-27.

60 *Supra,* note 55, at 5181.

61 *Supra,* note 14.

62 *Supra,* note 17.

63 *Supra,* note 15.

On one hand, the decision in *Merchant* blurs the neat symmetry that otherwise would be achieved if the matching principle were limited to post-paid financing costs. On the other hand, there are good reasons for treating rent and management fees on a similar footing to financing costs in that they are all "periodic expenditures". Financing costs relate to the use of money over a period, rent relates to the use of property over a period and management fees relate to the obtaining of services over a period. These kinds of expenditure are distinguishable from expenditure incurred in purchasing trading stock and on this basis, it is submitted that it is possible to reconcile the outcome in *Merchant* with that in *Woolcombers.* It is also possible to reconcile the different outcomes in *Merchant* and *Lau* notwithstanding that both cases involved, *inter alia,* management fees. It is submitted that the cases are distinguishable on the basis that *Lau* concerned pre-paid expenditure whereas *Merchant* did not.

E. *Estimated Versus Contingent Liabilities*

It is clear from the discussion so far that it is well settled that a liability will not be treated as having been incurred where it is merely contingent. It is only when a taxpayer has completely subjected itself to a loss or outgoing, in the sense that a presently existing liability exists, that the loss or outgoing will be treated as having been incurred. An issue that arises is whether or not a taxpayer can completely subject itself to a liability where the quantum of the liability cannot be precisely ascertained at the relevant time. In other words, is a deduction available in a particular tax year for a liability which may only be capable of estimation in that year? The answer to this question lies in a string of insurance cases which are discussed below.

1. *The Insurance Cases*

There is early authority for the proposition that an insurer's estimated provision against insurance claims that have not settled are deductible in the year that the event giving rise to the claim arose. This principle can be traced back to *FC of T* v *Manufacturers' Mutual Insurance Limited*[64] which concerned a former general deduction provision.[65] In that case, Ferguson J stated:

[64] (1931) 31 SR (NSW) 575.

[65] Section 19(1)(a) of the Income Tax (Management) Act 1928 (NSW).

> ... [T]here is no legal obligation in the sense of a cause of action immediately enforceable against the company; but from a practical business point of view, and that is the point of view from which these questions should be regarded, it is just as certain that some money will have to be paid in respect of pending claims as in respect of claims which have gone to judgment. The amount is uncertain, but apparently it is susceptible of more or less accurate estimate. Any statement of the affairs of the company professing to show the result of the year's operations, which neglected to take into account of this liability, would be grossly inaccurate and misleading. In my opinion, therefore, it is an obligation standing on the same footing as an actual expenditure, which the company is entitled to deduct as a loss or outgoing actually incurred in producing the assessable income, subject of course to any necessary future adjustment.[66]

The above passage was approved by Fullagar J in *Ballarat Brewing Co Ltd* v *FC of T*[67] and by Hill J in *FC of T* v *MMI (Workers Compensation) Ltd & Anor*[68](discussed below). It illustrates a desire to approach the problem from a "practical business point of view" and demonstrates that the fact that the amount of a liability cannot be precisely ascertained does not necessarily mean that the liability has not "come home". The two matters are separate issues.

In the modern era, the leading case dealing with estimated liabilities is *RACV Insurance Pty Ltd* v F*C of T*.[69] The issue in this case was whether a third party personal insurer was entitled to deductions for the amounts it had set aside to cover claims it anticipated would arise out of car accidents that were unreported at the end of the income year. Menhennitt J of the Victorian Supreme Court held that deductions were available for its reasonable estimate of such claims. His Honour indicated that "a loss or outgoing is incurred ... once the events giving rise to a liability occur". He found that, under the policies there was an "unanswerable liability to indemnify the driver of the vehicle once the personal injury occurs"[70] and that the liability was not dependent on notice of the injury or of the accident or upon a claim being made by the driver for indemnity. His Honour distinguished *James Flood* pointing out that the circumstances of that case were "in marked contrast with the position where an absolute liability to

66 *Supra*, note 64, at 585.
67 (1951) 82 CLR 364.
68 *Supra,* note 12, at 4407.
69 *Supra,* note 10.
70 *Ibid,* at 4183.

indemnify arises under an insurance policy upon the happening of events which result in the death of or bodily injury to a third person".[71] According to his Honour "the fact that the quantum of the loss or outgoing is a matter of estimate and that the amount may have to be adjusted in the light of later events"[72] did not preclude the loss or outgoing from being treated as having been incurred.

The *RACV* decision was applied in another Victorian Supreme Court decision three years later in *Commercial Union Assurance Co of Australia Ltd* v *FC of T*.[73] The facts of the case had similarities with, but were not identical to, the *RACV* case. In particular, like in *RACV,* deductions were claimed for estimates of unreported insurance claims at the end of the relevant year. However, unlike in *RACV*, the relevant policies often contained a clause stating that, unless the insured provided the insurer notice of the relevant event giving rise to a claim within a specified time,[74] the insured would be in breach of the policy with the result that the insurer could technically avoid liability. Newton J found that given that the taxpayer's general practice was never to rely on such a clause, as a matter of "commercial reality" it had completely subjected itself to liability under the policies.[75]

The principles developed in the preceding two cases were found to be equally applicable to a self insurer in *Australia & New Zealand Banking Group Ltd* v *FC of T*.[76] In this case, the Full Federal Court allowed a bank deductions for its estimate of its workers' compensation liabilities in relation to both reported but "unpaid claims" as well as "unreported claims". Hill J (with whom Lockhart and Northrop JJ concurred) found that, under the relevant statutory scheme, from the moment that an employee suffered an injury in the course of his or her employment, a presently existing liability to make payments in the future arose. This meant that liabilities relating to injuries sustained during a particular year would be incurred in that year even though no claim may have been made until a subsequent year and the amount of such claim may only be precisely quantifiable at some point of time in the future.

71 *Ibid,* at 4182.

72 *Ibid,* at 4176.

73 *Supra,* note 11.

74 The policies contained words such as "forthwith" and "as soon as possible".

75 His Honour indicated (*supra,* note 11, at 4193-4194): "Payment was a matter of commercial certainty, and was not subject to any contingency which would be regarded as such in the world of ordinary business affairs. The policy and practice was based on business expediency, and it is well established that payments made for reasons of business expediency, although otherwise voluntary, are not excluded from the category of allowable deductions under sec 51, because not made in pursuance to any legal obligation ..."

76 *Supra,* note 26.

It is relatively easy to distinguish *RACV, Commercial Union* and *Australia & New Zealand Banking Group* from *Nilsen* and *Ogilvy & Mather* based on the facts of the cases. In the insurance cases the event which gave rise to the liability (*ie,* the event insured against) had occurred. In contrast, in *Nilsen* the leave had not been taken and in *Ogilvy & Mather* the advertisement had not been published. There is therefore nothing in the insurance cases which stands against the principle that a taxpayer must be definitely committed to a liability in order to have incurred it. What the cases demonstrate is that where an insurer has become definitely committed to a liability as a result of the occurrence of an insured event, the fact that the liability cannot be precisely determined at such time will not preclude the insurer from claiming a deduction for its "reasonable estimate" of the liability.

2. *Reasonable Estimate*

The better view is that ever since Ferguson J's judgment in *Manufacturers' Mutual Insurance,* the law has required that a provision for claims made by an insurer must be "susceptible of more or less accurate estimate"[77] to be deductible. In this respect, it is important to note that none of the insurance cases discussed above involved fanciful "guesstimations". It is doubtful whether the courts would have allowed deductions for "unreasonable" estimates of provisions made for claims. What is reasonable in a particular case will, no doubt, depend upon factors such as the taxpayer's business experience and actuarial calculations. As Lord Loreburn indicated in *Sun Insurance Office* v *Clark*:[78]

> There is no rule of law as to the proper way of making an estimate. There is no way of estimating what is right or wrong in itself. It is a question of fact and figures whether the way of making the estimate in any case is the best way for that case.[79]

This passage was approved by Hill J in the *Australia & New Zealand Banking Group* case, where his Honour explained that:

> The concept of "estimate" does not involve arbitrarily seizing upon any figure. What is involved is the formation of a judgment or opinion based upon reason. That judgment or opinion must necessarily be made *bona fide* but it need not be exact for the process of estimation involves a process of approximation.[80]

[77] *Supra,* note 64, at 585.
[78] [1912] AC 443.
[79] *Ibid,* at 454.
[80] *Supra*, note 26, at 4035.

Similar observations have been made earlier on by Newton J in the Victorian Supreme Court decision in *Commonwealth Aluminium Corp Ltd* v *FC of T,*[81] where his Honour stated:

> I think that the quantum of a liability is "capable of reasonable estimation", if it is capable of approximate calculation based on probabilities ...[82]

The concept of an estimate has most recently been examined in *FC of T* v *MMI (Workers Compensation) Ltd & Anor.*[83] This case concerned the deductibility of provisions made by an insurance company in relation to claims reported during the relevant year which were not settled before the end of that year as well as claims arising during the year which were not reported before the end of the year. In line with the previous insurance cases, the Full Federal Court confirmed that the taxpayer had a presently existing obligation in respect of the claims. The major issue in the case concerned the quantum of the taxpayer's claim. The taxpayer had sought a deduction for its "central estimate" of its liabilities and added a "prudential margin" to cover against the central estimate being too low. The Court held that the common law did not support the Commissioner's argument that where there is a presently existing liability to pay money in the future, it is the present value of that obligation which is deductible in the year the liability arose.[84] According to the Court, the taxpayer was entitled to a deduction for the amount of its central estimate as well as the prudential margin. Hill J explained this conclusion as follows:

> To relate the outgoing required to be paid to investment income which subsequently might be earned on a capital sum set aside in the accounts is not what section 51(1) is concerned with. Accordingly ... there is no room in the present case for reducing the amount of the liability which has accrued by the making of a present value calculation.

[81] *Supra,* note 30.
[82] *Ibid,* at 4161.
[83] *Supra,* note 12.
[84] This argument was based on the approach contained in para 106 of *Taxation Ruling* IT 2663 which states: "The method to be used ... to arrive at an insurer's proper and reasonable estimate of an appropriate amount of provision in respect of outstanding claims at the end of a year of income is to adopt the amount which the insurer calculates as necessary to set aside in that year out of its premium (and other) income and which, when invested, will provide sufficient funds to pay the claims in the future." The view expressed by the Court accords with the view of the High Court in *FC of T* v *The Myer Emporium Ltd* (1987) 163 CLR 199 where the Court pronounced that the accounting basis for calculating profits and losses under the Income Tax Assessment Act 1936 is based on "historical cost" rather than "economic equivalence".

> ... [I]t is true that in calculating the provision in the accounts the prudential margin is applied not to the central estimate but to the discounted value of that estimate. It is true also that for tax purposes the prudential margin percentage has been applied to the central estimate. But mathematically the two are the same thing, save that the one figure is a discounted version of the other. Once it is accepted that the application of the prudential margin leads to an estimate which is more likely to be correct than the figure initially arrived at, there is no reason why the adjustment should not be made.[85]

The task of estimation is, as Hill J indicated in the *Australia and New Zealand Banking Group* case, a "commercial one".[86] As is evident from the above quoted passage, the reason why the taxpayer in *MMI* was entitled to a deduction for the prudential margin on top of its central estimate was because this equation produced a figure which was "more likely to be correct". In other words, the use of the central estimate together with the prudential margin provided a more accurate estimate of the liability than the use of the central estimate alone.

The High Court has recently refused the Commissioner special leave to appeal the *MMI* decision.[87] As a result, the Assistant Treasurer announced[88] that the Government will make legislative amendments to ensure that the deductions available to general insurers for outstanding claims will be calculated on the basis of discounted value.[89] In other words, deductions will be based on the amount required to be set aside in a particular year that, when invested, is sufficient to fund relevant claims in a future year.

3. *New Zealand Experience*

The above discussion has focused on cases involving insurers. This therefore raises the question as to whether or not other kinds of taxpayers are also entitled to deductions for estimates of their liabilities or whether the "reasonable estimate" principle is confined only to one special kind of taxpayer.

[85] *Supra,* note 12, at 4418.
[86] *Supra*, note 26, at 4035.
[87] See further, C Bevan, "MMI, the High Court and the "referability principle" (2000) *CCH Tax Week* ¶199.
[88] Press Release No 7 (18 February 2000).
[89] The amendments will be made retrospective to the 1991/92 year which was the year in which *Taxation Ruling* IT 2663 commenced: see *supra,* note 84.

There is Privy Council authority[90] in *C of IR (NZ)* v *Mitsubishi Motors New Zealand Ltd*[91] which suggests that the reasonable estimate principle is not limited to insurers. This case concerned a taxpayer that sold new cars through franchised dealers. The taxpayer had agreed to indemnify the dealers against the cost of warranty claims made against the dealers by their customers. The relevant warranties covered a period of 12 months or 20,000 kilometres (whichever occurred first) and required the purchaser to notify the dealer of a defect "as soon as reasonably possible within 21 days of becoming aware of the defect". The Privy Council held that the taxpayer was entitled to a deduction[92] for its reasonable estimate of its costs under expected warranty claims in the year that the cars were sold. According to the Privy Council, in the light of all the surrounding circumstances, a legal obligation to make payments in the future had accrued to the taxpayer at the time the cars were sold. In delivering the judgment of the Court, Lord Hoffmann reviewed the leading Australian cases and drew a distinction between expenditure which was "definitely committed" even though it was only capable of estimation at the relevant time and mere "contingent liabilities". In this respect, his Lordship stated:

> ... [A]lthough the jurisprudential approach prevents one from treating an aggregate of contingent liabilities as a statistical certainty, it does not rule out statistical estimation of facts which have happened but are unknown. Thus in *RACV Insurance Pty Ltd* v *Commissioner of Taxation* ... an insurance company carrying on accident business was allowed to make a deduction from its premium income of an estimated sum to represent its liabilities "incurred but not reported". These liabilities were not in law contingent. The accidents which gave rise to the company's liability had happened but the company did not know about them. A similar decision was reached in *Commercial Union Assurance Co of Australia Ltd* v *FC of T* .... Both cases were cited with approval in the High Court of Australia by *Mason* J (with whom *Aickin* J and *Wilson* J agreed) in *Nilsen Development Laboratories Pty Ltd* v *FC of T* .... The learned judge distinguished them from the cases on contingent liabilities because the accidents which gave rise to the liabilities under the policies had occurred during the relevant year of account. In the later case of *Coles Myer Finance Ltd* v *FC of T* ...

[90] Such authority is only of persuasive value in Australia since appeals to the Privy Council have been abolished: see *Viro* v *R* (1978) 141 CLR 88 and also Privy Council (Limitation of Appeals) Act 1968 and Privy Council (Appeals from the High Court) Act 1975.

[91] (1995) 95 ATC 4711.

[92] Under section 104 of the Income Tax Act 1976 (NZ).

> *McHugh* J remarked that the insurance cases involved a strained application of the earlier Australian decisions. This is true only in the sense that from a practical point of view, the distinction which they draw is irrelevant. But jurisprudentially the difference is clear enough.[93]

It is considered that *Mitsubishi Motors* represents a sensible interpretation of the law and should not be limited in its application to the New Zealand context.[94] There is no sound policy reason for only allowing insurers deductions for provisions made in respect of unreported claims. Other kinds of taxpayers should be in the same position provided they can demonstrate that their liabilities are not "mere contingencies" and that they are capable of reasonable estimate.

IV. Conclusion

Overall, Australian judges have been reluctant to categorically define what is meant by the term "incurred". This is not surprising given the warnings of one former High Court Chief Justice who has cautioned that "[i]t is unsafe to attempt exhaustive definitions of a conception intended to have such a various or multifarious application".[95] Indeed, another former High Court Chief Justice has gone so far as stating that "exhaustive definition of what may be denoted by the word 'incurred' ... may not be possible".[96]

In drawing the line between liabilities that have been incurred and those that have not, the Australian Courts have relied on colourful terminology to separate the cases. They have distinguished between, on the one hand, liabilities to which a taxpayer is "definitely committed" or "completely subjected to" (in other words liabilities that have "come home" to the taxpayer) and, on the other hand, liabilities that are merely "impending" "threatened" "expected" or "contingent". One might expect that the Singaporean courts would embrace similar language and rely on many of the Australian authorities in this regard as persuasive precedents.

One should, however, be cautious in assuming that all of the Australian authorities discussed in this article would necessarily be adopted by the Singaporean courts. This is because there are differences between the relevant legislative provisions. Whilst both the Australian and Singaporean deduction

[93] *Supra*, note 91, at 4715.

[94] For the Commissioner's view on the *Mitsubishi Motors* case, see *Taxation Ruling* IT 2648.

[95] *Per* Dixon J (as he then was) in *New Zealand Flax Investments Ltd* v *FC of T, supra,* note 33, 207. The fact that it is unsafe to exhaustively define the meaning of the word incurred has been reconfirmed in other cases. See, for example, *per* Sweeney and Gummow JJ in *Hooker Rex, supra,* note 35, at 4400.

[96] *Per* Barwick CJ in *Nilsen, supra*, note 22, at 624.

provisions contain the word "incurred", they place the word in slightly different contexts. In particular, the Singaporean provision does not contain the expression "to the extent that". Rather, it provides that for the purposes of "ascertaining the income of any person for any period ... there shall be deducted all outgoings and expenses wholly and exclusively incurred during that period". One will have to wait and see what relevance the different wording has in the application of the provision. It may be precisely because the word "incurred" appears in a different framework that the Singaporean courts may be reluctant to endorse the referability principle which, since the High Court delivered its decision in *Coles Myer,* has become such a well entrenched canon of Australian taxation law.

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