Privy Council Appeal No. 65 of 1994

The Commissioner of Inland Revenue *Appellant*

v.

Mitsubishi Motors New Zealand Limited *Respondent*

FROM

THE COURT OF APPEAL OF NEW ZEALAND

JUDGMENT OF THE LORDS OF THE JUDICIAL COMMITTEE OF THE PRIVY COUNCIL, Delivered the 3rd October 1995

Present at the hearing:-

Lord Keith of Kinkel
Lord Jauncey of Tullichettle
Lord Mustill
Lord Nicholls of Birkenhead
Lord Hoffmann

*[Delivered by **Lord Hoffmann**]*

Mitsubishi Motors New Zealand Limited ("MMNZ") sells motor vehicles through franchised dealers with the benefit of a warranty against defects appearing within a year of delivery or until the vehicle has been driven for 20,000 km, whichever period is the shorter. The question in this appeal is whether, in computing its "profits or gains" for the purpose of income tax, it can bring into account its anticipated liabilities under warranties remaining unexpired at the end of the year of account in which the vehicles were sold.

Income tax is levied upon "assessable income", which by section 65(2)(a) of the Income Tax Act 1976 includes "all profits or gains derived from any business". The term "profits or gains" is not defined. *Prima facie*, therefore, it bears its ordinary meaning as it would be understood by a businessman or accountant. As Dixon J. said in *Commissioner of Taxes (South Australia) v. Executor Trustee and Agency Co. of South Australia Ltd.* (1938) 63 C.L.R. 108, 152:-

"Income profits and gains are conceptions of the world of affairs and particularly of business ... In nearly every department of enterprise and employment the course of affairs and the practice of business have developed methods of estimating or computing in terms of money the result over an interval of time produced by the operations of business, by the work of the individual, or by the use of capital. The practice of these methods of computation and the general recognition of the principles upon which they proceed are responsible in a great measure for the conceptions of income, profit and gain and, therefore, may be said to enter into the determination or definition of the subject which the legislature has undertaken to tax."

The evidence of accounting practice adduced before Doogue J. left no doubt about the proper treatment of the outstanding warranty liabilities. They were part of the cost of the vehicle sales and therefore, so far as capable of reasonable estimation, should be matched against the corresponding revenue. The evidence satisfied the judge that a reasonable estimate could be placed upon the anticipated liabilities. All vehicles which leave MMNZ's assembly plant at Porirua have been tested and examined for defects. So far as MMNZ is aware, there is nothing wrong with them. Nevertheless, experience shows that in many cases, a defect will be discovered during the warranty period. Often it is no more than a blemish in the paintwork. Sometimes it is more serious. 63% of the vehicles sold by MMNZ in the year 1988 were returned to the dealers for some kind of work to be done under the warranty. Although it cannot of course be predicted whether any particular vehicle will turn out to be defective or how serious the defect will be, MMNZ can make a reasonably accurate forecast, based on previous experience, of what will be the total cost of remedial work for all the vehicles sold in a given year. Normal commercial practice therefore requires that this amount should be brought into account as a deduction from income in estimating the profits or gains of the business in the year in which the vehicles were sold.

The term "profits or gains" in section 65(2)(a) must however be read subject to the provisions of sections 101 and 104 of the Income Tax Act 1976:-

"101. 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.

104. In calculating the assessable income 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."

These sections have been construed to mean that in the calculation of the profits or gains of a business, the income side of the account is computed according to normal accounting principles but that "expenditure or loss" may be deducted only if it can be brought within the terms of section 104. In this respect the New Zealand Income Tax Act 1976 differs from the United Kingdom Taxes Acts, which contain the equivalent of section 101 (section 817(1)(a) of the Income and Corporation Taxes Act 1988) but no equivalent of section 104. The United Kingdom courts, faced with a statute which says that no deductions are to be allowed except those expressly enumerated and then fails to enumerate any permitted deductions, have felt able to treat the concept of "profits or gains" as containing within itself a direction to make such deductions as normal accounting practice would require for the purpose of computing profits or gains. But section 104, which does expressly define the scope of the permitted deductions, makes it difficult to apply an accounting practice which is not in accordance with its express terms. In addition, although not for present purposes relevant, there is section 106, which prohibits the deduction of various enumerated items of expenditure even if they come within section 104. It is not suggested that the warranty costs fall within any of the prohibited items and nothing more need therefore be said about section 106.

In construing section 104, the New Zealand courts have followed Australian authorities on the meaning of "losses and outgoings ... incurred" in section 51(1) of the Income Tax Assessment Act 1936 and the equivalent provisions in earlier legislation. The phrase has been held to mean that the taxpayer must have either paid or become "definitively committed" to the expenditure. In *A.M. Bisley & Co. Ltd. v. Commissioner of Inland Revenue* (1985) 7 N.Z.T.C. 5,082, 5,096 Henry J. summed up the effect of the authorities, both Australian and New Zealand, in four propositions:-

"First, a particular expenditure is 'incurred' for tax purposes in an income year if it constitutes an existing obligation which arose in the course of that year. Second, where the expenditure arises under a written deed or agreement, whether or not it constitutes an existing obligation is a question of construction of that deed or agreement. Third,

> that the expenditure is not payable until some future date does not of itself destroy its nature as an existing obligation. Fourth, that the expenditure is a defeasible liability does not of itself destroy its nature as an existing obligation."

There are two points about this construction which must be noted. First, it treats section 104 as concerned with particular items of expenditure rather than the aggregate sums which would concern a businessman drawing up his accounts. Each item, to be deductible, must satisfy the test of being an "existing obligation". This is to be contrasted with the normal commercial principles applied to the computation of profits or gains. As Lord Radcliffe said in *Southern Railway of Peru Ltd. v. Owen* [1957] A.C. 334, 357:-

> "The answer to the question what can or cannot be admitted into the annual account is not provided by any exact analysis of the legal form of the relevant obligation ... You get into a world of unreality if you try to solve your problem in that way, because, where you are dealing with a number of similar obligations that arise from trading, although it may be true to say of each separate one that it may never mature, it is the sum of the obligations that matters to the trader, and experience may show that, while each remains uncertain, the aggregate can be fixed with some precision."

The second point is that the question of whether the expenditure has been "incurred" involves characterising the nature of the legal relationship between the taxpayer and the person to whom the obligation is owed. On one view, it requires one to decide as a matter of construction whether the obligation is contingent or vested but defeasible. This is a nice distinction which can easily become a matter of language rather than substance and on which judicial views may differ; for an example, see *C.I.R. v. Glen Eden Metal Spinners Ltd.* (1990) 12 N.Z.T.C. 7,270. Both points illustrate the fact that this construction involves taking what the Australian courts have called a jurisprudential rather than a commercial view of the meaning of "incurred". This is an unusual approach to a taxing statute and their Lordships detect in the Australian cases some degree of tension between loyalty to formal legal doctrine and reluctance to accept a computation of taxable profits which is wholly divorced from commercial reality.

Although there are clearly parallels between the Australian and New Zealand legislation, there is also a striking difference. Unlike the New Zealand Act, the Australian Income Tax Assessment Act 1936 does not purport to levy tax upon "profits or gains". It defines "taxable income" in section 6 as "the amount

remaining after deducting from the assessable income all allowable deductions". Section 25(1) defines "assessable income" as gross income and section 51(1) governs allowable deductions:-

> "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 except to the extent to which they are losses or outgoings of capital, or of a capital, private or domestic nature, or are incurred in relation to the gaining or production of exempt income."

Thus the Australian Act taxes the gross income less allowable deductions. Although both of these concepts necessarily involve some reference to accounting principles, the statutory scheme does not apply the same principles to the relationship between them. In New Zealand, however, the use of the words "profits or gains" to describe the subject-matter of the charge to tax does *prima facie* require that income and expenditure should be related to each other in accordance with normal accounting principles. In *Commissioner of Inland Revenue v. Farmers' Trading Co. Ltd.* [1982] 1 N.Z.L.R. 449, 456, Richardson J. remarked upon this feature of the New Zealand legislative scheme, in relation to the Land and Income Tax Act 1954, as producing a "curious inconsistency". Mr. MacKenzie, who appeared for the taxpayer, submitted that the Board should remove the inconsistency by departing from the Australian authorities and construing "expenditure or loss ... incurred" in section 104 to include all items of expenditure or loss which would be deductible on normal accounting principles. This was a submission which, in view of the weight of contrary authority in New Zealand, he had felt unable to make to the Court of Appeal. Their Lordships think that it is not without a certain attraction, but would be reluctant to adopt so revisionist an approach without a more thorough inquiry into its possible repercussions on other parts of the legislation and the commercial practices which may have been designed around the established view of the law. Since their Lordships feel able to dispose of this appeal on the basis of existing authority, they would prefer to keep the more fundamental point open.

Since the question of whether the warranty costs have been incurred within the year in which the vehicle was sold is primarily a matter of construction, their Lordships must set out the terms of the warranty. Strictly speaking, the warranty is given by the franchised dealer to the retail purchaser, but since MMNZ agrees to indemnify the dealers against the cost of warranty claims, any obligation incurred by the dealer will result in a simultaneous obligation being incurred by MMNZ. The warranty is as follows:-

"1. The vendor of the new vehicle described herein warrants to the original purchaser and subsequent owners that if in normal use and service during the relevant warranty period as provided below any defect appears in the material or workmanship of any part of the vehicle not otherwise warranted, and as soon as reasonably possible within 21 days of becoming aware of the defect, the purchaser returns the vehicle to the vendor's premises and notifies the vendor of the defect, the vendor will at the vendor's cost either (a) supply and fit, or (b) repair any such part acknowledged by the vendor to be defective.

2. This warranty shall not apply if the vehicle has been repaired or altered in any way other than by the vendor or in any service workshop not authorised by the vendor, or if the vehicle has been subjected to misuse neglect or accident, or if it has been loaded beyond manufacturer's loading capacity or operated in such a way that is not recommended by the manufacturer.

3. The vendor shall not be liable for any loss or any consequential loss damage or expenses arising directly or indirectly from the defect.

4. This warranty is in lieu of all warranties terms conditions or representations expressed or implied whether by common law or statute.

5. The new vehicle warranty period shall be 12 calendar months after delivery of the vehicle to the original purchaser or until the vehicle shall have run 20,000 km whichever first occurs."

There was a difference of opinion between Doogue J. and the Court of Appeal over the effect of this warranty. Doogue J. construed it as a promise that the vehicle was free from defects at the time of sale, so that in the case of a defective vehicle, liability was incurred at the moment of delivery. The purchaser's failure to comply with the conditions of the warranty was merely a ground upon which MMNZ might be able to avoid an existing liability. In the Court of Appeal, however, Richardson J. held that any liability was contingent upon a defect appearing and being notified within the warranty period. Until then, no liability had been incurred.

On this point their Lordships agree with the Court of Appeal. But they do not agree that the form in which the warranty is expressed is the end of the matter. There are two other principles which must also be taken into account. The first is that although

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 *R.A.C.V. Insurance Pty. Ltd. v. Commissioner of Taxation* [1975] V.R. 1 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. Federal Commissioner of Taxation* (1977) 14 A.L.R. 651. 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. Federal Commissioner of Taxation* (1980-1981) 144 C.L.R. 616, 632. 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. Federal Commissioner of Taxation* (1992-1993) 176 C.L.R. 640, 679, 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.

The relevance of this principle is that estimation on the basis of statistical experience can be used to conclude that 63% or thereabouts of the vehicles sold by MMNZ in fact had defects which would manifest themselves within the warranty period of twelve months or 20,000 km. The finding of Doogue J. on the evidence was that "63% or thereabouts of all vehicles sold by [MMNZ] contain defects". Since this information could only be derived from MMNZ's experience of warranty claims, their Lordships understand the finding to mean that this was the level of defects notified to dealers in accordance with the terms of the warranty. It also seems a fair inference that the defects were present at the time of sale. Mr. Andrew Park Q.C., who appeared for the Commissioner, said that the terms of the warranty did not require that the defect should have existed at the time of sale. It could have come into existence within the warranty period. As a matter of construction, this is true. It is however hard to imagine the circumstances in which a defect in the "material or workmanship" of the vehicle would appear within 12 months of sale unless it was present, even if hidden, at the time the vehicle left the assembly plant. At any rate Mr. Park could not think of an example. In deciding whether MMNZ had incurred a liability at the time when the vehicle was

sold, it is therefore legitimate to have regard to the evidence establishing that 63% would in fact have had defects.

This, however, is not in itself enough to show that a liability was incurred. As has been said, their Lordships agree with the Court of Appeal that the language in which the warranty was expressed made liability dependent upon the manifestation and notification of the defect within the 12 month period. But the Australian authorities show that the question of whether the taxpayer is "definitively committed" to an expenditure or whether it is merely "impending, threatened or expected" (to adopt the language used in the leading case of *Federal Commissioner of Taxation v. James Flood Pty. Ltd.* (1953) 88 C.L.R. 492, 506-507) does not depend simply upon whether future events which may determine liability are expressed in the language of contingency or defeasance. Their Lordships think it would be strange if a concept so eminently practical as the computation of profits for income tax depended upon theoretical distinctions more appropriate to the rule against perpetuities. The question is rather whether, in the light of all the surrounding circumstances, a legal obligation to make a payment in the future can be said to have accrued. For this purpose, merely theoretical contingencies can be disregarded. In *Coles Myer Finance Ltd. v. Federal Commissioner of Taxation* (1992-1993) 176 C.L.R. 640, 671-2, Deane J. gave some examples of linguistic contingencies which were so unlikely as not to affect the certainty of the obligation. And in *Commercial Union Assurance Co. of Australia Ltd. v. Federal Commissioner of Taxation* (1977) 14 A.L.R. 651, 659-660, Newton J. felt able to disregard a condition in an insurance policy requiring notice of the occurrence of an insured event to be given within a stipulated time on the ground that, according to the evidence, the condition was hardly ever insisted upon.

If one asks whether in respect of each of the vehicles sold by MMNZ, the warranty conditions make its liability contingent in substance as well as in form, the answer must be yes. A substantial number - 37% - will have no defects at all. But, for the reasons given above, their Lordships think it legitimate to narrow the focus to those vehicles which left the assembly plant with defects of a kind likely to manifest themselves within the warranty period of twelve months or 20,000 km. That 63% of vehicles had such defects was a matter of existing fact, not future contingency. Since these defects were by definition likely to show themselves within the warranty period, their Lordships consider that the contingency that the owners might be content not to require remedial work would be real only in the case of the most trivial defects. It would not make any material difference to the accuracy of the estimated amount of expenditure to which the taxpayer could be said, as a matter of law, to be definitively committed.

Their Lordships would therefore respectfully differ on this point from the Court of Appeal and agree with Doogue J. that the warranty costs were deductible under section 104. This makes it unnecessary to express any concluded view upon the alternative basis upon which the Court of Appeal found for the taxpayer, namely that MMNZ could retrospectively apportion the price of each vehicle between the hardware and the warranty and then treat the warranty income as earned over the warranty period. Their Lordships are bound to say, however, that they have some difficulty with this method of reaching what is undoubtedly a sensible answer. The question of what income can be treated as "derived" during an accounting year is, unlike the question of deductions, a matter governed by normal accounting principles. If MMNZ had actually made a separate charge for the warranty, there would be no difficulty about treating that income as earned over the warranty period rather than at the moment of sale. But there was no justification in the accounting evidence for retrospectively treating part of the sum agreed by the parties to be the price of the car as if it had been a separate charge for the warranty. On the contrary, the taxpayer's expert accountant said that the whole price of the vehicles should be recognised as income and a deduction made for the warranty costs. It was on this basis that the statutory accounts were prepared. The fact that, as the Court of Appeal held, the warranty costs could not be deducted for the purposes of income tax cannot in their Lordships' view alter the accounting principles which govern the recognition of income. If upon its true construction the Income Tax Act 1976 requires the "profits or gains" of a business to be computed without deducting part of the cost of the business, it cannot be right, tempting as it may be, to compensate for the anomaly by manipulating the ordinary rules for the recognition of income. Fortunately their Lordships do not think that such measures are needed in this case.

The taxpayer also advanced a further alternative argument based upon the complicated group of sections 64B to 64M which are headed "Accrual Treatment of Income and Expenditure Relating to Financial Arrangements". In view of the conclusion they have reached on the question of deductions, it is unnecessary for their Lordships to say anything about this argument and they prefer not to. Their Lordships will humbly advise Her Majesty that the appeal ought to be dismissed. The Commissioner must pay the respondent's costs before their Lordships' Board.