BARRIE NELSON SWEETMAN

v

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THE COMMISSIONER OF INLAND REVENUE

[HIGH COURT, 1993 (Fatiaki J), 20 April]

Appellate Jurisdiction

Income tax-allowable deductions-whether repayment from firm's income of money stolen by a partner was wholly and exclusively expended for the purpose of the business-Income Tax Act (Cap. 120) Section 19(b).

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A partner in a firm of solicitors stole money from trust accounts. The remaining partners reimbursed the accounts from partnership income and sought to deduct the payments from their taxable income. The Court of Review for taxation disallowed the deductions. On appeal to the High Court, allowing the appeal it was HELD: the reimbursements were expenditure wholly laid out for the purpose of the business.

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Cases cited:

CIR v. Flour Mills of Fiji Ltd (Civ. Appeal 6 of 1985)
CIR v. Southern Pacific Insurance Co. (Fiji) Ltd (Civ. App. 38 of 1983)
Dennis Williams v. CIR (Civ. Appeal 17 of 1991)
Edwards v. Bairstow [1956] A.C. 14
Gray v. Lord Penrhyn (1937) 3 All E.R. 468
Mallalieu v. Drummond (Inspector of Taxes) [1983] 3 W.L.R. 409
Mitchell v. B.W. Noble Ltd. [1927] A.C. 719
Phillip Rice v. The Commissioner of Inland Revenue (1950) 4 F.L.R. 33
Strong & Co. of Ramsey Ltd v. Woodfield (1906) A.C. 448
W.G. Evans & Co. Ltd v. CIR [1976] 1 NZLR 425

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Appeal to the High Court from the Court of Review.

M. Johnson with *R. Smith* for the Appellant
G.A. Keay for the Respondent

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Fatiaki J:

This is an appeal against the decision of the Court of Review established pursuant to Section 63 of the Income Tax Act (Cap. 201).

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In particular the taxpayer challenges the decision of the Court of Review delivered on the 19th of September 1991 upholding the assessment of the Commissioner of Inland Revenue disallowing a deduction claimed by the taxpayer.

This appeal is brought pursuant to Section 69 of the Income Tax Act which provides inter alia that the Court:

> "... shall hear and consider such matter upon the papers and evidence referred ..."

A It is well to remind oneself of what the Court of Appeal said of the nature of an appeal such as the present in CIR v. Southern Pacific Insurance Co. (Fiji) Ltd. Civil Appeal No. 38 of 1983 (unreported judgments) where the Court said at pp. 4 and 5:

> "During the argument Mr. Handley informed us ... that the appeal
> B to the Supreme Court was by virtue of Section 69, by way of rehearing. We have not had the benefit of argument on the matter but we doubt if that be so.
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> The scheme of the Section is that an appellant's notice of dissatisfaction with reason therefor is given to the Commissioner
> C who is required to "refer the matter" to the Supreme Court "for hearing and determination".
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> The taxpayer's appeal is embodied in his notice which contains his reasons therefor. And it is that upon which the Supreme Court is required to adjudicate."

D In Edwards v. Bairstow [1956] A.C. 14 Lord Radcliffe set out the principles upon which a Court can interfere with the findings of a commissioner set out in a case stated when he said at p. 36:

> "When the case comes before the court it is its duty to examine the determination having regard to its knowledge of the relevant
> E law. If the case contains anything ex facie which is bad law and which bears upon the determination, it is, obviously, erroneous in point of law. But without any such misconception appearing ex facie, it may be that the facts found are such that no person acting judicially and properly instructed as to the relevant law could have come to the determination under appeal. In those
> F circumstances too, the court must intervene. It has no option but to assume there had been some misconception of the law and that this has been responsible for the determination. So there too, there has been error in point of law."

In this instance the taxpayer's Notice of Dissatisfaction with the decision of
G the Court of Review contains the following reasons:

> "(1) That having found that the risk of the defalcations on which the reparative expenditure by Munro, Leys & Co. was incurred was inherent in that firms business operations, and that such expenditure was not of a capital nature, the Court of Review erred in law in finding that such expenditure could not

be deducted by the firm from its income;

(2) That the Court of Review was wrong in finding that because the thefts committed by Mr. Benefield had no connection with his professional activities the reparative expenditure incurred thereon by Munro, Leys & Co. could not be deducted by that firm from its income."

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The facts of the case are not in dispute and are set out in the judgment of the Court of Review as follows:

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> "The appeals arise from the fact that one Michael Desmond Benefield, who was a partner in the appellant's firm from 1975 to 1984 stole a considerable amount of money from the firm's trust account. An agreed statement of facts was put in, but Mr. Sweetman (the taxpayer) also gave evidence on oath. From that evidence it appears that the thefts took place over a considerable period - probably a number of years - and that the moneys held in the firm's trust account, although under the absolute control of the firm's partners, are held on the instructions of the various clients, who are able to draw it out when they wish and how they wish. After it was ascertained what had been stolen, the money was repaid from the firm's income, and the partners sought to set the amount repaid off as a loss of revenue."

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The Court of Review in its judgment considered Section 19 of the Income Tax Act and held: "that the money is not expenditure of a capital nature" in terms of the proscription contained in subsection (1). This aspect of the Court of Review's decision is not challenged by either party and need not concern this Court any further in this appeal.

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In so holding it is also apparent that the Court of Review accepted " ... that the circumstances in which this partnership was carried on where each partner could draw upon the firm's account, the risk of defalcations was inherent in their operations."

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Those two holdings however only satisfy the requirements of Section 19(1). They do not dispose of the matter or render the expenditure deductible in determining the total income of the firm or its partners. In order for such an expenditure to be deductible it must additionally avoid the proscription contained in Section 19(b).

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In this latter regard in considering the question of whether the expenditure was "wholly and exclusively laid out or expended for the purpose of the taxpayer's profession" in terms of Subsection (b) of Section 19, the Court of Review after

referring to various authorities said, in dismissing the appeal:

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> "In my view his (Mr. Benefield's) thefts arose altogether outside his professional activities, and had no connection with them."

It is convenient at this stage to set out the provisions of Section 19(b) of the Income Tax Act (Cap. 201) which reads:

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> "19. In determining total income, no deductions shall be allowed in respect of
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> (b) any disbursement or expense not being money wholly and exclusively laid out or expended for the purpose of the trade, business, profession, employment or vocation of the taxpayer."

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It is clear on a careful reading of the above subsection that there are two limbs or elements which must be satisfied or fulfilled before any expenditure is deductible. These are:

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> Firstly, the expenditure must be "wholly and exclusively laid out or expended"; and secondly, the expenditure must be "for the purpose of the trade profession, business, employment or vocation of the taxpayer".

(my underlining)

Recently the Fiji Court of Appeal had occasion in CIR v. Flour Mills of Fiji Ltd. Civil Appeal No. 6 of 1985 to consider the meaning and ambit of Section 19(b) of the Income Tax Act.

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The Court of Appeal in its judgment examined fully the decision of the House of Lords in Mallalieu v. Drummond (Inspector of Taxes) [1983] 3 W.L.R. 409 which dealt with Section 130(a) of the Income and Corporation Taxes Act, 1970 which for all practical purposes is identical in terms to our Section 19(b).

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In approving the judgment of the House of Lords the Court of Appeal said at p. 14:

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> "Here the statutory provision under consideration is the same as the provision obtaining in England. And the latter has obtained in England in various Income Tax Acts in identical terms at least since 1842 ... and the House of Lords has over the long years ... adjudicated upon the construction of the provision. It is of course, trite to say that the construction of a statutory provision is a matter of law but we say it to emphasise that the law involved in the construction of the equivalent of Section 19 of the Fiji Act has been settled since Strong & Co. of Ramsey

> Ltd. v. Woodfield was decided in 1906 (1906 A.C. 448) and affirmed anew on many occasions culminating in the Mallalieu case three quarters of a century later. All these matters render the present case a classic instance for treating Mallalieu as a very great persuasive authority." A

Then at p. 17 the Court of Appeal said:

> "It is not the word "exclusively ..." as it is used in Section 19(b) which imparts the necessity for a subjective test. The adverb so used in Section 19(b) qualifies the phrase "laid out or expended for the purposes of trade ..." and in no manner touches the question as to whether a subjective test or an objective test should be applied in ascertaining the taxpayer's intentions. As Lord Brightman put it in Mallalieu (op cit p. 414 E) - "the effect of the word "exclusively" is to preclude a deduction if it appears that the expenditure was not only to serve the purposes of the trade, profession or vocation of the taxpayer but also to serve some other purpose." B C

> "Rather it is the word "for" in the phrase which imports the subjective test. It turns the inquiry to the taxpayer's reason or reasons for making the expenditure and leads to the necessity to explore the taxpayer's mind to discover his intention or intentions up to the point in time when the expenditure was made." D

and later at p. 26 of its judgment the Court of Appeal said:

> "The distinction between the word "purpose" as used "in the statutory sense" as the Judge has put it and "purpose" as a synonym for "object" or "intention" was dealt with by Lord Brightman in the Mallalieu case in which he said, at page 414A:" E

> "The words in the paragraph "expended for the purposes of the trade, profession or vocation mean in my opinion "expended to serve the purposes of the trade, profession or vocation"; or as elaborated by Lord Davey in Strong & Co. of Ramsey Ltd. v. Woodfield [1906] A.C. 448, 453 "for the purpose of enabling a person to carry on and earn profit in a trade etc." The particular words emphasised do not refer to "the purposes" of the taxpayer as some of the cases appear to suggest. They refer to "the purposes" of the business which is a different concept although the "purpose" (i.e. the intentions or objects) of the taxpayer are fundamental to the application of the paragraph." F G

Finally in regard to the use of Australian cases in interpreting Section 19(b) the Court of Appeal observed at p. 29:

> "We ... are of the opinion ... that the Australian cases provide no authority to determine the deductibility of legal costs under the English Counterpart of Section 51(1) (Australian Income Tax Assessment Act 1936) and likewise the latter's counterpart in Fiji - Section 19(b)."

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In similar vein this Court derives little assistance from the New Zealand decisions which are based on the construction of Section 80 of the Land and Income Tax Act 1923 and its successor Section 111 of the Land and Income Tax Act 1954 both the wordings of which differ materially from section 19(b).

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I do not apologise for citing so extensively from the judgment of the Fiji Court of Appeal which is not only binding on this Court but more so because the judgment dealt specifically with the statutory provision presently under consideration.

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From the judgment it is clearly necessary to ascertain the "purpose(s)" for which the expenditure was made by the taxpayer.

In this regard the taxpayer himself testified before the Court of Review in the following brief extract: (at p.13 of the record)

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> "Moneys taken from client's trust accounts and used by him. We accepted that we had to repay that money and we have done so."

and in cross-examination:

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> "Firm held in respect at the time, I think ... We never sought to escape liability for any of those moneys and could not have done so. I accept that I might have been liable myself."

and later by way of expansion he said: (at p. 16 of the record)

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> "There were a number of incidents of theft by Benefield, spread over a period of time, probably over several years, involving a number of different clients. The money represented funds held in trust account on behalf of various clients, and used on their instructions. The funds which were stolen were held in trust for clients and had to be repaid on demand."

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The Court of Review in its sole reference in its judgment to the purpose of the expenditure had this to say : (at p. 21 of the record)

> "With all respect to Mr. Johnson I would have thought that, in view of Section 12 of the Partnership Act, the nature of the expenditure spoke for itself."

It is clear from that statement that the Court of Review considered that the purpose of the expenditure was to meet the liability of the firm to make good the loss occasioned by the misappropriation of monies belonging to third persons by a partner of the firm acting within the scope of his apparent authority. A

I have not the slightest doubt that such a purpose is within the contemplation of Section 19(b) in so far as it was "... expended to serve the purposes" of the firm.

B Having so-stated what the purpose of the expenditure was, the Court of Review appears to have overlooked or ignored it altogether in its consideration of Section 19(b).

In similar vein the Court of Review appears to have also ignored its finding that " ... the risk of defalcations was inherent in the (firm's) operations". Indeed in its consideration of Section 19(b) the Court of Review appears to have been unduly influenced by the position and authority of the defaulting partner in the firm. C

In so-doing in my view the Court of Review erred in its assessment of the meaning and effect of Section 19(b).

D There can be no doubting that in making the repayments the partners of the firm including the taxpayer were seeking to secure the good name of their firm albeit that coincidentally it had the effect of discharging their several and joint liability for the stolen trust monies pursuant to the provisions of Section 13 of the Partnership Act (Cap. 248).

E The presence however of this latter beneficial effect of the expenditure is not necessarily fatal to its deductibility as is clear from the judgment of Lord Brightman in Mallalieu's case when he said at p. 414F:

> "The object of the taxpayer in making the expenditure must be distinguished from the effect of the expenditure. An expenditure may be made exclusively to serve the purposes of the business, but it may have a private advantage. The existence of that private advantage does not necessarily preclude the exclusivity of the business purposes." F

I am fortified in my view by the judgment of Carew P.J. in Phillip Rice v. The Commissioner of Inland Revenue (1950) 4 F.L.R. 33 in which the office of a firm of solicitors (of which co-incidentally the present Court of Review was a partner) was broken into and a sum of money was stolen. Part of the sum was trust monies and had to be refunded and part was money earned and owned by the firm. G

In ruling that the trust monies stolen was a deductible expense (as opposed to the monies belonging to the firm) the learned judge said at p.36:

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> "But as regards the trust money, different considerations apply. In order that their clients should suffer no loss the firm replaced the sums stolen. In doing so the firm had its interests and good name to consider. I think that the amount refunded was a proper business out-going. It was a loss in the sense contemplated by Lord Loreburn. In coming to this view, I rely on the principles as they were applied to the facts in the case of Gray v. Lord Penrhyn [1937] 3 All E.R. 468 and the case of Mitchell v. B.W. Noble Ltd. [1927] A.C. 719."

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In my view the status or authority of the defaulting partner in this case is unlike the defaulting director type of case' insofar as this is a case involving property that did not belong to the firm and also where the Court of Review has found that the risk of defalcations was inherent in the manner in which the business of the firm was being conducted.

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In similar vein Casey J. said in W.G. Evans & Co. Ltd. V. CIR [1976] 1 NZLR 425 at p. 435:

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> "The fact that he was also a director, shareholder and officer of the company does not alter the fact that he misappropriated the money while dealing with it as part of the company's activities, and not by the exercise of overriding power or control outside those activities altogether, as did the sole managing director in Curtis's case. The risk of defalcations was inherent in the operations of the company carried on by necessity in this way, and accordingly the resulting loss is fairly incidental to the production of the assessable income and is deductible."

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For the above reasons the appeal is allowed with costs to the appellant. For the sake of completeness the appeal in Civil Appeal No. 17 of 1991 Dennis Williams v. CIR, which was to abide the outcome of the present appeal as agreed by counsels is also allowed with costs.

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(Appeal allowed)

(Editors note: An appeal against this Judgment was allowed by the Fiji Court of Appeal on 12 May 1994 (FCA Reps 94/204). A final appeal to the Supreme Court restored this Judgment on 23 October 1996 (FCA Reps 96/582) and will be reported in 42 FLR)

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