IN THE COURT OF REVIEW

Review No.9 of 1983

BETWEEN:

REDDY CONSTRUCTION CO. LTD - APPELLANT

A N D

THE COMMISSIONER OF INLAND REVENUE RESPONDENT

Mr. B.C. Patel for the Appellant

Mr. M.J. Scott for the Respondent.

J U D G M E N T

The appellant and a British Company, Sir Lindsay Parkinson & Co. Ltd., which I will refer to as the British Company, were interested in obtaining the tender for the building of the new Lautoka Hospital and to facilitate this work entered in or about June 1970 into what is called a Pre-bidding agreement. That agreement was based upon the British company being awarded the contract for the hospital in which case the two companies agreed to enter into a joint venture. One of the terms of the pre-bidding agreement was that each of the two companies was to contribute $50,000 to fund the joint venture. The contract was duly awarded to the British company and the parties formed a fresh company called Parkinson-Reddy Ltd., the main object of which was to carry out the conditions of the contract for the erection of the Lautoka hospital and an agreement was made on 17th June, 1971 whereby the British company sub-contracted

the main contract for the hospital to Parkinson Reddy Ltd. Each of the parties paid its $50,000 in accordance with the pre-bidding agreement. Unfortunately the joint venture lost money and the appellant's $50,000 became irrecoverable. The appellant sought to deduct this $50,000 from its taxable income but the respondent, the Commissioner, disallowed the appellant's claim. The appellant therefore appealed and a statement of agreed facts was filed including among those agreed facts the appellant's notice of objection which contains its statement of moneys received for plant hire. Counsel for the appellant told the Court that the appellant's claim to a deduction was based upon section 19(b) of the Income Tax Act, Cap.201. That section reads:-

> "19. In determining total income no deduction shall be allowed in respect of
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> (a).........
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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."

Mr. Patel, for the appellant, in opening his appeal, pointed out that the Commissioner, by quoting Jacob-Young v Harris (1926) 11 TC 221 in his letter of 5th October, 1983 had confined himself to averring a loss of capital which would be under section 19(i). In my view this is quite irrelevant, for the onus of proof is upon the appellant and the appellant has to satisfy the Court, on a balance of probabilities, that the money was wholly and exclusively laid out for the purposes of the business of the appellant. Mr. Patel contended that this $50,000

was provided for the joint venture in the hope and expectation of producing profits for the appellant, that it was in fact a loan to the joint venture, although without interest or terms of repayment. The pre-bidding agreement called the $50,000 contributed by each party 'working capital', and, as I understood him Mr. Patel suggested that 'working capital' was what has been called 'circulating capital' as distinct from 'fixed' capital. Then Mr. Patel distinguished this 'working capital' from the share capital of Parkinson Reddy Limited, which was two dollars. In this case I am quite unable to distinguish fixed capital from circulating capital. There is no evidence. The fact of the matter is that the British Company and the appellant each paid $50,000 to the joint venture. Both of those sums were lost. I can come to no other conclusion than that each provided the capital. It was not money laid out for the appellant's business, but for that of the joint venture. The motive may have been to obtain profits for the appellant but that was not the purpose of the disbursement of $50,000. The purpose was to fulfil the terms of the pre-bidding agreement and provide 'working capital' for the joint venture. Mr. Patel referred to a New Zealand case, Green v. Inland Revenue Commissioner (1969) 1 ATR 61. He stressed the comments of Woodhouse J that it is the actions of the appellant and not the subsidiary company that are vital. But, even accepting that dictum it seems to me that all that the appellant did

was to furnish money which was to be the capital of the joint venture. It was called 'working capital' but there is no evidence as to what it was used for or how it was used. All that the Court was told was that the money was paid out to Parkinson Reddy Limited and is now irrecoverable.

Mr. Patel directed the attention of the Court to the pre-bidding agreement. Article 1 shews that the agreement is of a temporary nature for the purpose of preparing a tender for the construction of the Lautoka hospital which was to be in the name of the British company and was in fact to be a joint tender. Article 3 provides that if the British company was successful in obtaining the tender the appellant and the British company would enter into a joint venture, and a sum would be added to the tender for directors' fees and the parties were to be entitled to charge the joint venture for travelling and incidental expenses of persons visiting Fiji on behalf of the joint venture. Then there was to be a Board of Management in which the parties would have equal representation, but the Chairman would be one of the British company's representatives who would have the final say, subject to the appellant's right to go to arbitration. Then the appellant was to supply all necessary plant and equipment to the joint venture and was entitled to receive hire charges, although the joint venture would pay insurance. Article 4 provides that each party would supply 50% of the working capital required for the execution of the works to a maximum of $50,000. In fact each of the parties did contribute $50,000.

Under Article 5 the interpretation of the contract is to be in accordance with the laws of England, and Article 6 provided that the agreement was to terminate if the English Company were not awarded the contract. Then Article 7 provided that any conditions or financial guarantees provided were to be given by the British Company. Mr. Patel has also drawn my attention to the Memorandum of Articles of Parkinson Reddy Ltd., but those contain nothing unusual save that each party to the joint venture has the right to appoint two directors, and that in the event of disagreement between the directors appointed by the British company and the directors appointed by the appellant, the matter of disagreement would be referred to arbitration. I do not attach very much importance to the fact that the share capital of Parkinson Reddy was only $2. Mr. Patel submitted that the $50,000 was not an investment, but was working capital. Mr. Patel says that working capital is circulating capital, as distinct from fixed capital. Swinfen Eady L.J. discusses the two in Ammonia Soda Company v Chamberlain (1918) 1 Ch.266, 77 L.J. Ch.153. That was a case in which it was alleged that directors of a company had paid dividends out of capital and was not a tax case at all. Swinfen Eady L.J. said at p.289 of the Law Reports (L.J. Ch.203) "directors are not under any obligation to recoup any lost capital before dividing net profit subsequently earned, and if money of a company be lost before any profits have been earned, it can only be capital which has been lost."

Viscount Haldane L.C. in Smith (John) & Son v. Moore (1921) 2 A.C.1319:90 L.J. P.C.149 152: 12T.C.266 282 delivering the leading judgment, after referring to the fact that the distinction between fixed and circulating capital took its rise from Adam Smith's well known book "Wealth of Nations" observes "Adam Smith described fixed capital as what the owner turns to profit by keeping it in his own possession, circulating capital as what he makes profit of by parting with it and letting it change masters. The latter capital circulates in this sense". Then in Regent Oil Co. Ltd., v. Strick (1965) 3 AER 174, 180 3 W.L.R.636, 43 T.C.1 Lord Reid said "Things which the trader uses in his business to produce what he has to sell are part of his fixed capital and their cost is a capital outlay although their useful life may be short. Things which he turns over in the course of his trade are circulating capital and their cost is a revenue expense." Also on the distinction between fixed and circulating capital, Lord Pearce in delivering the judgment of the Privy Council in B.P. Australia v. Federal Commissioner of Taxation (1965) 3 AER 209 219: 3 W.L.R. 129: 112 CLR 386 said: Fixed capital is prima facie that in which one looks to get a return by one's trading operations. Circulating capital is that which comes back in one's trading operations. Then Lord Dunedin in Vallombrosa Rubber Co. v. Farmer (1910) 5 T.C. 529, 536 said "..... in a rough way I think it is not a bad criterion of what is capital expenditure as against what is income expenditure to say that capital expenditure is a thing that is going to be spent once and for all and income expenditure is a thing that is going to recur every year." In this case the payment was a once and for all payment because the joint venture was for the construction of a building which was to be completed within a relatively short time and did indeed

enure only over two accounting periods. Looking at the present case from the point of view of each of those statements of the distinction between fixed and circulating capital, I would have thought that there is little doubt that the payment constitutes fixed rather than circulating capital and there is no doubt in my mind at all that the expenditure was not of a revenue nature.

Mr. Patel also referred to Levin and Co. v I.R.C. (1963) 9 ATR 301: NZLR 801. There the appellant was a stock and station agent in a large way of business and carrying on business also as a merchant bank. It made substantial advances to a subsidiary company. It was held that that part of the advances made in the ordinary course of the appellant's business was deductible, while that part of the advances which was made to keep the subsidiary company alive was a capital risk and could not be deducted. The judgments of the New Zealand Court of Appeal in this case indicate that it is necessary in each case to ascertain the true nature of the transaction. Here Mr. Patel submits that because the appellant had power under its memorandum to lend money, the money put into the joint venture being an advance must be treated as money expended wholly in earning the assessable income of the appellant. But as has been pointed out every properly drawn memorandum of association normally gives a company power to lend money. There is no evidence that the appellant is engaged in the business of lending money. McCarthy J. suggested in the Levin case (page 331) that losses incurred as a result of advances to a subsidiary to establish that subsidiary or to support it in an hour of need are not deductible.

Herald and Weekly Times Ltd. v F.C.T. (1932) 48 CLR 113, 118 was also referred to. That was a case where the newspaper quite often incurred expense in defending claims for defamation and the Commonwealth High Court held that such expenditure was a loss or outgoing actually incurred in gaining or producing the taxpayer's assessable income on the basis that the libels were published with the object of selling the newspaper, and the claims were encountered because of the very act of publishing a newspaper. I cannot see that the appellant can gain much assistance from that case.

The case was heard on 29th February 1984 and on 19th March after most of this judgment had been written, Mr. Patel wrote in referring the Court to two new authorities, Sun Newspapers v FCT (1938) 61 CLR 337 and B.P. Australia Ltd. v FCT (1965) 112 CLR 386: 3 AER 209: 3 WLR 608: (1966) A.C. 224 and he also referred to the New Zealand Master Tax Guide at pp.346, 347. Mr. Scott protested that the Court should not look at these cases seeing that so long a period had elapsed since the hearing. However, the Court's view is that it should look at any authority submitted before judgment is delivered, so long as in this case, submission of the authority is not accompanied by argument, and would call upon counsel again if necessary. Citation of these two cases would indicate that Mr. Patel is shifting his ground, for they both deal with capital as against income. I have not seen the New Zealand Master Tax Guide. In the Sun Newspapers case, a large lump sum was paid, in effect to buy up a competitor and stifle competition, and that was held to be a capital disbursement.

In the B.P. Australia case lump sums paid for site agreements with retailers of petrol were held to be expenditure of a revenue nature. In the Sun Newspapers case Dixon J in the High Court of Australia suggested a threefold test which was made use of in the B.P. Australia case by Lord Pearce and also by Lord Wilberforce in Regent Oil Co. v Strick (1965) 3 AER 209: 3 WLR 636 43 T.C.l. He said at 61 CLR 363 "There are, I think, three matters to be considered -

(a) the character of the advantage sought and in this its lasting qualities may play a pert;
(b) the manner in which it is to be used relied upon or enjoyed, and in this and under the former head recurrence may play its part and
(c) the means adopted to obtain, that is by providing a periodical reward or outlay to cover its use or enjoyment for periods commensurate with the payment or by making a final provision or payment so as to secure future use and enjoyment."

It is probable that in this case the ultimate advantage sought was profits from the construction of the hospital, but I think that was too remote, and I think that the real advantage sought was the association with the British Company in the building of the hospital. The British Company would seem from its name, to be a firm of

good repute, and the contract would provide work for one or two years. The advantage, put in the way it has suggested itself to me, would appear to be a capital advantage, rather than a revenue advantage.

Megarry J. in Pitt v Castle Hill Trading Co. (1977) 1 WLR 1624, 1629: 49TC 638 put the matter another way. He said: It seems to me that Strick v Regent Oil Co. and B.P. Australia v FCT (both cit supra) establish that in determining whether expenditure is incurred on revenue account or on capital account one must consider at least three elements. First what is the nature of payment. Is there a single non-recurrent lump sum, paid once and for all, on the one hand, or are there to be current payments made, for example, for periods commensurate with those payments? Second, what is to be obtained by the payment? Is it some asset with lasting or enduring qualities, or is it merely ephemeral or indeed, something which cannot be described as an asset, whether tangible or intangible. Third, in what manner is what is obtained to be used relied on or enjoyed? Will it have a quality of recurrence which will point to an income nature, as by providing a flow of orders for goods or will it bear a move static aspect which points to a capital nature?" I confess that I find

this analysis far easier to understand than that of Dixon J. Here there is a lump sum paid once and for all. The asset obtained by the payment was a half interest in the joint venture - in Parkinson Reddy Ltd., a limited company with a legal and business structure, and it was to be enjoyed by the provision of dividends, and perhaps, even, if profits were made, by distribution of the profits on liquidation. Megarry J. goes on to put forward the most modern view, "In considering all these elements, and in looking at the case as a whole, it is the practical and business view that counts far more than the juristic classification of the legal rights employed or exhausted in the process." It is a question of fact and degree and above all judicial common sense in all the circumstances of the case."

Perhaps I should say something about Commissioner of Taxes v Nchanga Consolidated Copper Mines (1964) 1 AER 208, AC.94, 2 WLR 339, which might be said to be the case most favourable to the appellant. There Viscount Radcliffe, delivering the judgment of the Privy Council stressed the importance of observing a line of demarcation between the cost of creating acquiring or enlarging the permanent structure of which the income was to be the produce or fruit and the cost of earning operations. There a very large sum paid by

two companies of a group to a third as compensation for the abandonment of its production of one year was held to be income. But there no capital asset was created by the assumption by the two companies of the output of the third and the whole transaction was to be begun and ended within the year. Here Parkinson-Reddy's building activities begun in 1972 did not end until 1975.

Both counsel referred the Court to Silke on 'South African Income Tax', but in the view I have taken of the case, I have found it unnecessary to have recourse to South African authorities.

Mr. Patel's second point is that the Commissioner should have regarded the loss of $50,000 by Parkinson Reddy Ltd. as appellant's loss. I cannot see that in the circumstances of this case. Mr. Patel says that appellant, the British Company and Parkinson Reddy are to be considered as one entity. If that were so one would have expected that the British Company would have joined the appellant as appellants. But they could not do so, as they are not subject to Fiji Income Tax law. The appellant is, and Parkinsom Reddy probably is, but the British company is not. Mr. Scott argued that for the Court to, as it were, pierce the corporate veil in tax matters, legislation is required. I doubt if that is correct. It has been done in income tax cases before now. Atkinson J. in Smith Stone and Knight v Birmingham

Corporation (1939) 4 AER 116, 121 suggests that in each case it is a question of fact. Moreover the appellant and the British Company did not control Parkinson Reddy in the same way as, say, Smith Stone and Knight Ltd. controlled the Waste Company - see Smith Stone and Knight v. Birmingham Corporation (1939) cit. supra, or that D.H.N. Ltd., controlled the Bronze Company and D.H.N. Foods, see D.H.N. Ltd. v Tower Hamlets London Borough Council (1976) 1 WLR 852: 3 AER 462. Here appellant's directors could be obstructed by the British company's directors in any attempt to control Parkinson Reddy Ltd. and in the ultimate resort forced to an arbitration. I do not think that the business realities of this situation at all warrant the Court in treating these three companies as one entity. The appeal fails and will be dismissed, with the result that the appellant will pay the Commissioner's costs.

(K.A. Stuart)
Court of Review

6th April, 1984.

Solicitors: Stuart Reddy & Co., Lautoka, Solicitors to the Inland Revenue.