BARRIE NELSON SWEETMAN & DENNIS JULIUS WILLIAMS

A **v.**

THE COMMISSIONER OF INLAND REVENUE

[SUPREME COURT, 1996 (Cooke of Thorndon, Mason, Casey JJSC)
23 October]

B *Income Tax- reimbursement by partners of misappropriated funds- whether an allowable deduction from the partnerships taxable income- Income Tax Act (Cap. 201) Section 19 (b)- Partnership Act (Cap 248) Sections 12 & 13.*

Two remaining partners reimbursed trust funds which had been misappropriated by a former partner. They set off the money thus disbursed against the partnership income claiming that it represented money "wholly and exclusively" expended C for the purpose of their profession, an allowable deduction in terms of the Income Tax Act. On appeal from the Court of Appeal which reversed a finding by the High Court in favour of the taxpayers the Supreme Court, allowing the appeal HELD: that although the immediate purpose of the reimbursements was to discharge the personal liability of the partners the further professional purpose namely the restoration and maintenance of client confidence in the partnership D was sufficient to characterise the payments as having a professional purpose and therefore as being eligible for deduction.

Cases cited:

Allen v Farquharson Bros & Co. (1932) T.C. 59
E *Bamford v A.T.A..Advertising Ltd* (1972) 48 T.C. 359
Charles Moore & Co. (W.A.) Pty Ltd v Federal Commissioner of Taxation (1956) 95 C.L.R. 344
Commissioner of Taxation v. Ash (1938) 61 C.L.R. 263
Fletcher v Federal Commissioner of Taxation (1991) 173 CLR 1
Gold Band Services Ltd v Commissioner of Inland Revenue [1961] N.Z.L.R. 467
F *Lowless v Beeson* (1952) 33 T.C. 491
Magna Alloys v F.C. of T. (1980) 33 A.L.R. 213
Mallalieu v Drummond [1983] 2 A.C. 861
Morgan v Tate & Lyle Ltd [1955] A.C. 21
Strong & Co. Ltd v Woodifield [1906] AC 448
G *W.G. Evans & Co. Ltd. v Commissioner of Inland Revenue* [1976] N.Z.L.R. 425

I. Gzell Q.C. and *M. Johnson* for the Petitioners
I. Blakeley and *A. Bale* for the Respondent

Judgment of the Court:

These applications for special leave to appeal seek to raise for determination the

question whether amounts expended by the taxpayers and their partners by way of reimbursement of clients of the partnership for moneys misappropriated from two trust accounts of the partnership were allowable deductions from the assessable income of the partnership. The parties in the second matter, the application by Mr. Williams, have agreed to be bound by the decision in the first matter. So we shall confine our discussion to that matter on the understanding that the facts which are common to both cases raise identical issues for decision.

A

The circumstances in which the misappropriations and the reimbursement took place are briefly set out in a statement of agreed facts lodged by the parties in the Court of Review and in oral evidence given by Mr. Sweetman in that court. The two taxpayers are barristers and solicitors who practise with another partner under the name "Munro Leys and Company". The three partners had practised in partnership with one Michael Desmond Benefield from 1975 until 31 May 1984. The statement of facts recites:

B

C

> "... Throughout this period, the usual responsibilities of partnership were accorded to each and every member of the firm. Mr. Benefield was then dismissed from the firm, subsequently struck off the roll of solicitors and was convicted by the Supreme Court of Fiji (now the High Court) for the offence of fraudulent conversion of a sum in excess of $13,000 from two trust accounts of the afore-mentioned firm.
>
> 3. The taxpayer [Mr. Sweetman] and his remaining partners decided to reimburse their clients for the misappropriated funds. In 1984, the payments were shown as a deduction from assessable income in the firm's profit and loss account on the basis that the reimbursement payments had been made wholly and exclusively for the purpose of their profession in terms of section 19 (b) of the Income Tax Act Cap. 201 ."

D

E

According to the Court of Review's summary of Mr. Sweetman's oral evidence, the misappropriation took place over a considerable period a number of years - and the moneys held in the firm's trust accounts, though under the absolute control of the partners, were held on the instructions of the various clients who were able to withdraw funds as and when they wished. The Court of Review judgment stated:

F

> "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."

G

The Commissioner disallowed the deduction claimed and subsequently disallowed the taxpayer's objection to the assessment. The taxpayer then appealed to the Court of Review pursuant to s. 62 (6) of the Income Tax Act ("the Fiji Act"). That Court upheld the assessment and dismissed the appeal.

The Court of Review held that the money was not "expenditure of a capital nature" within the meaning of s. 19 (i) of the Act. That conclusion was not challenged by either party on appeal. That conclusion was based, at least in part, on the Court's view that in:

> "the circumstances in which this partnership was carried on where each partner could draw on the firm's account, the risk of defalcations was inherent in their operations".

However, in concluding that the expenditure was not "wholly and exclusively laid out or expended for the purpose of the taxpayer's profession", in terms of s. 19 (b), the Court held

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

The taxpayer's appeal to the High Court of Fiji (Fatiaki J) from the Court of Review was successful. In reaching the conclusion that the expenditure fell within s. 19 (b), Fatiaki J relied upon the following evidence given by the taxpayer before the Court of Review:

> "Moneys were taken from client's trust accounts and used by him. We accepted that we had to pay that money and we have done so.
>
> ...
>
> Firm held in respect at that 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.
>
> ...
>
> 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 our 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."

In the light of this evidence, Fatiaki J considered that the purpose of the expenditure was to meet the liability of the firm "to make good the loss" occasioned by the misappropriation and that this purpose was within s. 19 (b).

The Commissioner then appealed from this decision to the Court of Appeal (Sir Mari Kapi, Ward and Thompson JJA). The Court of Appeal allowed the Commissioner's appeal, set aside the judgment of the High Court and reinstated the decision of the Court of Review. The taxpayer was ordered to pay the Commissioner's costs of the appeal and of the proceedings in the High Court and the Court of Review.

The Court of Appeal concluded that there was no error on the part of Fatiaki J in making a finding that the expenditure of the money by the taxpayer through the partnership was incurred for the purpose of his profession. Their Lordships considered that inferences could properly be drawn to justify that conclusion. However, their Lordships also concluded that the expenditure was not made "wholly and exclusively" for the purpose mentioned. They pointed out that several other purposes were possible, the most obvious being a desire not to be sued personally and not to lose his own personal (as distinct from his professional) reputation. The taxpayer, apart from stating that the payment was made to satisfy the liability of the partners, that being a personal liability which arose under s. 13 of the Partnership Act, did not give evidence of the purpose or purposes to be served by the making of the payment. The absence of that evidence means that the ascertainment of those purposes is a matter of inference. The absence of evidence of that kind may also have contributed to the Court of Review's approach to the taxpayer's claim. The Court's findings, as quoted above, suggest that it was looking at the claim as if the deduction was for a loss rather than an expenditure falling within s. 19 (b).

The taxpayer's proposed appeal attacks the correctness of the Court of Appeal's conclusion that the expenditure was not made "wholly and exclusively" for the purpose mentioned in s. 19 (b). The taxpayer's attack on the Court of Appeal's decision on this point involves a challenge to the way in which the Court of Appeal reached that conclusion. The law on the point, as it has been enunciated in authorities in other jurisdictions, is by no means clear and, for that reason, we consider that the case raises an important question of principle which this Court should resolve. We therefore grant special leave to appeal. We also grant special leave to appeal to the respondent to enable the respondent to challenge the conclusion that the purpose of the expenditure was for the purpose of the taxpayer's profession within s. 19 (b). The two conclusions are inter-related and it makes little sense to deal with one to the exclusion of the other.

We repeat that, as the Court of Review held that the payment was not "expenditure of a capital nature". This is no longer an issue between the parties. That conclusion and the finding on which it was based, namely that there was an inherent risk of defalcations arising from the circumstances where each partner could draw on the firm's account, requires consideration of the reasons of the High Court of Australia in Commissioner of Taxation v. Ash (1938) 61 C.L.R. 263 to which we refer later in these reasons.

The statutory provisions relevant to the questions of law

It is convenient to begin by referring to the relevant statutory provisions. Section 19 of the Act relevantly provides:

> "In determining total income, no deductions shall be allowed in respect of
>
> ...

(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;"

A

Section 61 (2) of the Act casts on the taxpayer the onus of proving that the assessment was incorrect.

By virtue of s. 51 of the Act, a partnership is required to make a joint return in respect of its income, but no assessment issues in respect of the partnership return. The income of each individual partner is assessed, each partner being required to make an individual return apart from the partnership return.

B

Sections 12 and 13 of the Partnership Act (Cap. 248) provide as follows:

"12. Where -

C

(a) one partner acting within the scope of his apparent authority receives the money or property of a third person and misapplies it; and

(b) a firm in the course of its business receives money or property of a third person and the money or property so received is misapplied by one or more of the partners while it is in the custody of the firm, the firm is liable to make good the loss.

D

13. Every partner is liable jointly with co-partners and also severally for everything for which the firm while he is a partner therein becomes liable under either of sections 11 or 12."

E

By virtue of s. 12 (1) (c) of the Court of Appeal Act (Cap. 12), where the High Court has exercised its jurisdiction under an enactment, a ground of appeal to the Court of Appeal is limited to a question of law. It was accepted by the Court of Appeal that whether the agreed facts and the evidence permitted or did not permit a finding to be made that the expenditure was money laid out or expended for the purposes of the taxpayer's profession was a question of law and likewise whether the agreed facts and the evidence permitted or did not permit a further finding to be made that the money was laid out or expended wholly and exclusively for that purpose.

F

The interpretation of s. 19 (b)

G

Section 19 (b)is identical to all intents and purposes with Rule 1 of Schedule D of s. 100 of the Income Tax Act 1842 (Eng.). There is a body of English authority which throws light on the meaning of this provision and its successors. It is convenient to begin with Strong & Co. Ltd v Woodifield [1906] AC 448. There the House of Lords held that the taxpayer, which carried on business as a brewer and innkeeper, could not deduct under Rule 3 of Schedule D damages and costs recovered by a customer who was injured by the fall of a chimney while sleeping

in the taxpayer's inn. Their Lordships apparently held that the payment of the damages and costs was not a loss "for the purpose of the [taxpayer's] trade" within the meaning of Rule 1. That rule, which deals with the deduction of a "loss", corresponds with s. 19 (c) of the Fiji Act, though it is expressed in different terms.

A

Lord Davey, who considered that the question fell to be decided by reference to Rule 1 rather than Rule 3, said, with reference to the words "for the purposes of the trade" (at p. 453):

B

> "These words ... appear to me to mean for the purpose of enabling a person to carry on and earn profits in the trade, etc. I think the disbursements permitted are such as are made for that purpose. It is not enough that the disbursement is made in the course of, or arises out of, or is connected with the trade, or is made out of the profits of the trade. It must be made for the purpose of earning the profits."

C

Lord Davey was unquestionably correct in regarding Rule 1 as the applicable provision. There is a distinction between a loss and an expenditure or a disbursement. Thus money stolen or misappropriated from a business is a loss not an expenditure, whereas legal expenses or costs are an expenditure or disbursement (Allen v Farquharson Bros & Co. (1932) T.C. 59 at 64 per Finlay J; Bamford v A.T.A..Advertising Ltd (1972) 48 T.C. 359 at 367 per Brightman J). In the present case, the misappropriation of funds by Mr. Benefield was a loss sustained by the old partnership. On the other hand, the reimbursement of the defrauded clients by the taxpayer and his continuing partners was a disbursement or an expenditure by them. Whether it was a disbursement which falls within s. 19 (b) is, of course, the critical question. But the distinction between a loss and a disbursement or expense is important because it fixes the focus of attention on the purpose of the actual expenditure rather than on the circumstances in which the misappropriation took place, though those circumstances will be relevant in characterising the expenditure.

D

E

To return to the passage which we have quoted from the speech of Lord Davey. The last sentence in the passage does not qualify the first sentence (Morgan v Tate & Lyle Ltd [1955] A.C. 21 at 39-40 per Lord Morton of Henryton; at 53-54 per Lord Reid). Morgan v Tate & Lyle Ltd was a decision on Rule 3 (a) applicable to Cases I and II of Schedule D to the Income Tax Act 1918 (Eng.), that rule being identical with s. 19 (b). In that case, expenditure on an anti-nationalisation campaign by a sugar refining company to prevent seizure of the business and assets of the taxpayer was held to be deductible under Rule 3 (a).

F

G

In order to ascertain whether the amount in question was expended to serve the purposes of the taxpayer's profession, it is necessary to discover the purpose or object of the disbursement. There is a well-recognised difference between motive and purpose. Here we are concerned with characterising the purpose of the expenditure in order to determine whether the expenditure was to serve the purpose

of the taxpayer's profession. in the case of involuntary expenditure pursuant to a contractual or other legal liability, the purpose of the expenditure usually will be A evident from the subject matter of the payment, i.e. the nature of the liability which it satisfies and the advantage which it procures, without the need to resort to evidence of the individual taxpayer's motives or intentions. (see Fletcher v Federal Commissioner of Taxation (1991) 173 CLR 1 at 17-18 per curiam; Magna Alloys v F.C. of T. (1980) 33 A.L.R. 213 at 233-235). In the case of voluntary expenditure, evidence of an individual taxpayer's motives or intentions, B with respect to the advantage that he had in view, may be relevant and influential in ascertaining the purpose of the expenditure (see Morgan v Tate & Lyle Ltd at 37, 47; Mallalieu v Drummond [1983] 2 A.C. 861 at 870; Magna Alloys v F.C. of T (supra).

The evidence was that the payment was made to satisfy the clients' loss, that is C to meet the liability of the old partnership "to make good the loss" occasioned by the misappropriation, in the words of Fatiaki J. That was the finding of fact made by the Court of Review. In deciding the case against the taxpayer, the Court of Review appears to have thought that the fact Mr. Benefield's thefts arose outside his professional activities and had no connection with them was the decisive consideration. Whether or not that comment would have been relevant, had the claim been a claim for deduction of a loss, the comment provides no D assistance in resolving the taxpayer's claim for a deduction under s. 19 (b).

The discharge by the continuing partners of the liability of the members of the old partnership to the clients of that partnership in respect of the misappropriation of the trust moneys is plainly an act calculated to enhance the earning capacity of the continuing partnership. The payment was calculated to induce the clients E whose moneys had been misappropriated to remain with the firm. It protected the firm against the adverse reputation it would have suffered had the partners refused to meet their liabilities. And it enabled the continuing partners to continue to practise as members of the firm, that being a possibility fraught with risk, had they been unwilling to meet their liabilities under s. 13 of the Partnership Act. The moneys misappropriated were not moneys belonging to the partnership: they F were trust funds which did not constitute capital of the partnership. In the light of these considerations, we consider that the Court of Appeal was entitled to hold, as it did, in view of the parties' acceptance of the Court of Review's finding that the disbursement was not in the nature of capital, that the disbursement was made for the purpose of the taxpayer's profession. That inference was clearly justified by the circumstances disclosed by the evidence, even though the taxpayer G did not, in his oral evidence, relate the making of the payment to the continuation of the firm's professional practice. To give oral evidence of that matter would be merely to state the obvious.

The contrary argument rests upon the reasoning in Commissioner of Taxation v Ash to which we referred earlier. There the taxpayer sought to deduct an instalment paid under a covenant entered into by way of compromise of an action. The action was brought to recover moneys misappropriated by his former partner.

the moneys belonging to clients of the firm. It was held that the payment was in the nature of an outgoing of capital. The Court acknowledged that theft of moneys by shop employees should, *prima facie,* be allowed as deductions on the footing that they are risks inherent in, or incidental to, the conduct of a business (supra at 273-274, 277, 281). As Rich J observed (at 277):

> "There is no difficulty in understanding the view that involuntary outgoings and unforeseen and unavoidable losses should be allowed as deductions when they represent that kind of casualty, mischance or misfortune which is a natural or recognized incident of a particular trade or business the profits of which are in question. These are characteristic incidents of the systematic exercise of a trade or the pursuit of a vocation ."

(See also Charles Moore & Co. (W.A.) Pty Ltd v Federal Commissioner of Taxation (1956) 95 C.L.R. 344 at 350-351 per curiam; W.G. Evans & Co. Ltd. v Commissioner of Inland Revenue [1976] N.Z.L.R. 425 at 430-432 per Casey J.)

However, in Commissioner of Taxation v Ash the Court distinguished misappropriation by a partner in a firm of solicitors from theft by an employee of a business on the ground that the formation of a partnership was essentially different from the employment of staff in a business (at 274 per Latham C J; at 278 per Rich J). Dixon J considered that this was so and the loss was a capital loss as a result of the taxpayer undertaking the risk of such a liability when, by entering into the partnership, each partner armed the other with an authority under which he might impose liabilities upon him (at 283).

Implicit in the other judgments is the ground of the decision as expressed by Dixon J (at 280-281) in these terms:

> "In my opinion the deduction is not allowable because of its nature. In the first place, it is evident that the actual payment of £500 was made only because of the antecedent liability. Once the compromise was made the amount agreed upon became a personal liability of the taxpayer ... and its discharge became a matter quite independent of his continuing to practice and quite unconnected with the earning of future income. It was simply a liability sustained and fixed in an earlier year."

We make the following comments about the reasoning in Commissioner of Taxation v Ash. The risk of misappropriation by a partner in a business or a profession is these days a natural incident of the carrying on of a business or profession and, in that respect, is not to be distinguished from the risk of theft by an employee in a business. That risk of loss is "inherent in the income-earning process of" a business or a professional practice, in the words of Casey J in W.G. Evans & Co. Ltd v Commissioner of Inland Revenue (supra at 433, referring

to Gold Band Services Ltd v Commissioner of Inland Revenue [1961] N.Z.L.R. 467). Likewise, the conduct of a professional practice by a partnership in a systematic and organised way with a view to the earning of fees and the making of profits is to-day not to be distinguished in a relevant respect from the carrying on of a business in such a way with a view to making profits.

A

In the context of capital and revenue, we see no persuasive reason to treat misappropriation by a partner as different from theft by an employee. The fact that a partner confers authority on a co-partner to subject the partner to liability is not a sufficient reason for saying that a liability arising from what is a natural incident of conducting a professional practice is necessarily a loss of a capital nature. Although the liability which arises in such a case is a personal liability under s. 13 of the Partnership Act, it is liability which arose here in the conduct of the partnership practice, the keeping and management of trust moneys being an incident of such a practice. Indeed, it is evident that neither a partner nor an employee has authority to misappropriate trust funds.

B

C

Moreover, the professional practice conducted by the old and the new partnership was a continuous practice, marked only by a change in the composition of the partners as Mr. Benefield retired from the partnership. To treat the loss as a loss of the old partnership to the exclusion of the new partnership is, in our view, to ignore the circumstance that the practice was a continuing practice despite the departure of Mr. Benefield.

D

Accordingly, we consider that the Court of Appeal was entitled to proceed, as it did, on the footing that the liability to the client was not a loss or outgoing in the nature of capital. Once that conclusion was reached, it was correct to characterise the payment in satisfaction of that liability as not being a disbursement in the nature of capital.

E

That conclusion, which disposes of the cross-appeal, brings us to the more difficult question: was the disbursement or expense money wholly and exclusively laid out or expended for the purpose of the profession of the taxpayer? The word "wholly" refers to the quantum of money expended and the word "exclusively" requires that the money be expended solely for the relevant purpose, i.e. for the purpose of the taxpayer's profession (Bentley v Stokes and Lowless v Beeson (1952) 33 T.C. 491 at 503-504 per Romer L.J.), that being essentially a question of fact. So, in this case, the answer to the difficult question turns on whether the moneys expended were exclusively laid out or expended for the purpose of the taxpayer's profession.

F

G

There has been some discussion as to whether it is to be resolved by reference to the motives of the taxpayer. In Mallalieu v Drummond, the taxpayer, who was a practising barrister, claimed a deduction for the cost of replacing and laundering black clothes which she wore in order to comply with professional dress standards set by the Bar Council. The commissioners found as a fact that she would not have bought them but for those standards and that the preservation of warmth and decency was not a consideration which entered her mind. The House of

Lords (by a majority of four to one, Lord Elwyn Jones dissenting) held that the expenditure was not exclusively incurred for the purposes of the taxpayer's profession.

A

Lord Brightman, with whom the other Law Lords in the majority agreed, stated ([1983] A.C. at 383) that, if the object of the taxpayer was to serve a business purpose and a non-business purpose, the fact that the business purpose is predominant is immaterial. His Lordship went on (at 387) to reject the notion that the object of the taxpayer "is inevitably limited to the particular conscious motive in mind at the moment of expenditure". His Lordship continued:

B

> "Of course the motive of which the taxpayer is conscious is of vital significance, but it is not inevitably the only object of which the Commissioners are entitled to find to exist. In my opinion, the Commissioners were not only entitled to reach the conclusion that the taxpayer's object was both to serve the purpose of her profession and also to serve her personal purposes, but I myself would have found it impossible to reach any other conclusion."

C

Although the passage just quoted acknowledges that there is a distinction between motive (what actuates the mind of the actor) and purpose (the character to be attributed to the act), the passage tends to blur that distinction. Motive may assist in the ascertainment of the purposive character of the relevant act, particularly when the expenditure is voluntary, but it does not by any means dictate an answer to the question.

D

In our view, the key to the question which arises in the present case lies in the words "wholly and exclusively" in s. 19 (b). The word "wholly" is designed to exclude a disbursement which, as to part, is for a purpose other than those mentioned, while the word "exclusively" excludes a disbursement which serves another purpose as well as a purpose mentioned. So an expenditure which serves the purpose of the taxpayer's profession but another purpose as well is not an allowable deduction.

E

It may be said that an expenditure which serves the purpose of the taxpayer's business or profession also serves the taxpayer's personal purposes on the basis that what is good for his business or profession will be good for him personally. However, it is scarcely to be supposed that the legislature intends to disqualify an expenditure for that reason. In other words, the non-business or non-professional purpose to be excluded by s. 19 (b) is a purpose distinct from the business or professional purpose which justifies the deduction of the expenditure. And this supports the view that motive, though it may be a relevant factor, is by no means a decisive factor. If the purpose of the expenditure is truly for the purpose of the taxpayer's business or profession, it matters not that the taxpayer has in mind some personal advantage which is a consequence of that purpose.

F

G

Here the immediate purpose of the expenditure was to discharge the personal

liability of the partners arising under s. 13 of the Partnership Act. Lying beyond that immediate purpose was unquestionably another purpose, namely the purpose A of restoring and maintaining client confidence in the firm, thereby maintaining or enhancing its profit-earning capacity. In these circumstances, is it possible to conclude that the moneys were laid out or expended exclusively for the purpose of the taxpayer's profession? In our view, the answer is in the affirmative. Although the immediate purpose of the payment was to discharge what was a personal liability, it was a partnership liability and was incurred in the capacity of a B partner. The fact that the liability was personal does not give the disbursement a character or purpose which is independent of the conduct of the professional practice of the taxpayer and his partners. The personal purpose served by the disbursement purpose was an integral element in the professional purpose which the disbursement served.

C The Court of Appeal was therefore in error in concluding that the moneys were not exclusively expended for the purpose of the taxpayer's profession and the appeal must be allowed.

The orders of the Court in the two matters are -

> Grant special leave to appeal. Appeal allowed with costs. Set aside D the orders of the Court of Appeal and order that the respondent pay the costs of the appellant of the appeal to the Court of Appeal. Restore the orders made by Fatiaki J in the High Court.

(Appeal allowed; orders of the High Court restored.)

E

F

G