Allowable Deductions and Tax Deferral: *Coles Myer Finance Ltd v FCT*

1. *Introduction*

In *Coles Myer Finance Ltd v FCT,*[1] a factually unexceptional case, the High Court considered the operation of the primary deduction provision, section 51(1) of the *Income Tax Assessment Act* 1936 (Cth). The case concerned the time at which the taxpayer, Coles Myer Finance Ltd, was entitled to allowable deductions for discounts on bills of exchange and promissory notes. At first glance the case appears to revolutionise the operation of the section, with one commentator claiming that the decision has "effectively rewritten" section 51(1).[2] Given statements like this and the fact that section 51 generates more tax disputes and litigation than any other section of the tax legislation, the case is one of the most important tax decisions to have come from the High Court. This note examines possible interpretations of the decision, including those given by four Federal Court judges in the *Woolcombers* case.[3] The reasoning of the High Court is considered, and a favoured interpretation is proposed. It is argued that the case continues the High Court's move towards a more commercial basis for the tax laws, without making compliance unduly onerous.

2. *Facts and Background*

Coles Myer Finance Ltd was the finance company for the Coles Myer group of companies. During the year ending 30 June 1984 (the 1984 year of income) the company drew and sold, at less than their face value, bills of exchange and promissory notes. At the time of drawing the bills and notes in question, the company received the proceeds ($105 264 527) in return for an obligation to pay out, at the maturity of the bills and notes, their full face value ($110 000 000). The bills and notes in question matured in the 1985 year of income, but the taxpayer claimed a deduction for the full amount of the discount ($4 735 473) in the 1984 year of income, being the year in which they were drawn and discounted.

Section 51(1) allows a deduction for "losses or 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". The taxpayer and the Commissioner of Taxation both agreed that the discount was deductible. But they disagreed as to which year of income the discount was incurred. The matter came before the Administrative Appeals Tribunal, and was subsequently referred to the Federal Court as a special case stated.[4] The Court had to decide whether the amounts

1 (1993) 112 ALR 322; 93 ATC 4214.

2 Richards, R, "High Court rewrites s51: Coles Myer Finance" (1993) *Butterworths Weekly Tax Bulletin* 234 at 234.

3 *Woolcombers (WA) Pty Ltd v FCT* 93 ATC 4342; (1993) 114 ALR 647 (Lee J) and *FCT v Woolcombers (WA) Pty Ltd* 93 ATC 5170 (Beaumont, French and Foster JJ).

4 Pursuant to s45 of the *Administrative Appeals Tribunal Act* 1975 (Cth) and Order 50 of the

claimed were a loss or outgoing incurred in the 1984 year of income, the 1985 year of income or partly in both. The Commissioner argued that the loss or outgoing was only incurred and hence deductible when the bills and notes matured. The Full Federal Court unanimously upheld the Commissioner's arguments.[5] The taxpayer appealed to the High Court, where the case was heard by the Full Bench.

3. *High Court Decision*

The traditional jurisprudential analysis of section 51(1), as expounded in cases such as *FCT v James Flood Pty Ltd*[6] and *Nilsen Development Laboratories Pty Ltd v FCT*,[7] seeks to establish a point in time at which the taxpayer's obligation is sufficiently fixed; this time is when the expenditure is regarded as incurred. The whole amount of the expenditure is then deductible in the period in which it is incurred. The test usually applied to determine if a loss or outgoing is incurred is to examine whether "there is a presently existing liability to pay a pecuniary sum, no matter how certain it is from a business viewpoint that an expense was incurred or accrued during the year of income".[8]

In a joint judgment, five Justices initially followed this traditional jurisprudential analysis by seeking to establish when the liability to pay the face value of the bills and notes on maturity arose. In contrast to the Federal Court, Mason CJ, Brennan, Dawson, Toohey and Gaudron JJ found that a present obligation to pay the face value of the bills and notes at maturity arose when the bills were drawn and the notes issued. As such, the loss or outgoing was incurred in the 1984 year of income. With regard to the promissory notes, the court had to reconcile this conclusion with the decision in *W Nevill & Co Ltd v FCT*.[9] The High Court in *Nevill* held that certain payments to be made by a company to a former director over a period of time pursuant to promissory notes were not deductible under section 51(1) in the year in which the notes were made, but were deductible when paid. Thus the decision could have been interpreted to have held that the obligation to pay the promissory notes was incurred when the notes matured. However, the majority refused to regard the decision as decisive because the point was not argued and comprehensive reasons were not given.[10]

But this was not the end of the matter. According to the majority:

> The acceptance by this Court of the jurisprudential analysis of s. 51 does not compel the conclusion that, once a taxpayer subjects itself in the year of income on revenue account to a present legal liability to pay in a future year of income an amount which generates, or gives rise to, a net loss or outgoing, the net loss or outgoing is deductible in full in the year of income ... there remains the

Federal Court Rules.

5 *Coles Myer Finance Ltd v FCT* 91 ATC 4087 (Sweeney, Northrop and Wilcox JJ).

6 (1953) 88 CLR 492.

7 (1980–1981) 144 CLR 616.

8 Above n1 at 4227–4228 per McHugh J.

9 (1937) 56 CLR 290.

10 Above n1 at 4220.

> question: how much of that net loss or outgoing is *referable* to the year of income?[11] (emphasis added).

Thus the majority appear to have added an extra requirement for deductibility. Incurring a loss or outgoing is seemingly not enough; there is a "remaining question": how much of that net loss or outgoing is referable to the year of income? In support of the remaining question, the court primarily relied upon similar statements by Dixon J in *New Zealand Flax Investments Ltd v FCT*.[12] That case dealt with the timing of deductibility of interest payments to bondholders. Dixon J held that only so much of the interest as was "properly attributable"[13] to the year in question could be deducted. Similar statements were also made in *FCT v Australian Guarantee Corporation Ltd*,[14] where a deduction was allowed for the amount of interest payable under deferred interest debentures as was "fairly referable"[15] to the year in question. This case was curiously not referred to in *Coles Myer Finance*.

As a result, the majority found that the cost of the notes and bills should be apportioned over the two years of income, as the taxpayer had put the funds to profitable advantage in both years of income. This apportionment was to be done on a straight line basis over the term of the relevant note or bill, "having regard to the relatively short life of the bills and notes".[16]

Additional support for this result came from a decision of a single judge in the Supreme Court of Victoria. Under section 51(1) a loss or outgoing is deductible only to the extent to which it is incurred in gaining or producing the assessable income. This provision was described by Menhennitt J in *RACV Insurance Pty Ltd v FCT*[17] as "a statutory recognition and application of the accountancy principle which all the accountants who gave evidence referred to as the matching principle".[18] This statement was approved by the majority in *Coles Myer Finance*.[19] The matching principle:

> [S]eeks to ascertain the net gain of a business during a particular year by matching against the income earned during that period the expenses and losses which, from a business point of view, were directly related to the earning of income during that period.[20]

In short, expenses should be matched with the revenue for a period according to the benefits derived from the expenditure in that period.[21] Application of the matching principle to this case also suggested that the discount should be apportioned over both years. As the majority said, "[a]pportionment of the cost over the two years of income therefore accords with both accounting principle and practice and the statutory prescription".[22]

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11 Id at 4222.
12 (1938) 61 CLR 179.
13 Id at 207.
14 84 ATC 4642.
15 Id at 4650 per Toohey J.
16 Above n1 at 4223.
17 [1975] VR 1.
18 Id at 14.
19 Above n1 at 4222.
20 Id at 4227 per McHugh J.
21 See Martin, C, *An Introduction to Accounting*, (3rd edn, 1990) at 161.
22 Above n1 at 4222.

Deane J agreed generally with what was said by the majority. McHugh J dissented. Like the majority, he found that the outgoing was incurred in the 1984 year of income. However, he followed the traditional jurisprudential analysis of section 51(1), hence finding that the outgoing was deductible in full in the year in which it was incurred. However, his judgment shows that his sympathies lie with the majority. He seemed to disapprove of the traditional jurisprudential analysis of section 51(1), describing it as "the natural result of the doctrine of legal formalism ... which has been rejected by this Court only in recent years".[23] But he felt compelled to apply traditional principles since neither party had argued for a different approach to the case.

4. *How is the "Remaining Question" to be Applied?*

A. *Possible Interpretations*

The impact of the decision on previous taxation jurisprudence has been hotly debated. At one extreme, Robert Richards has suggested that the decision applies only to bills of exchange and promissory notes.[24] He contends that the case applies only in these limited circumstances; similar to the way in which the cases concerning "claims incurred but not reported" are confined to insurance companies.[25] In so far as the case applies to bills and notes it is relatively clear. However, there is still uncertainty regarding which method of apportionment is appropriate. The majority used a straight line basis "having regard to the relatively short life of the bills and notes".[26] For bills and notes of longer duration, a yield to maturity basis may be more appropriate.[27]

Against this restrictive interpretation, the language of the majority is couched in broad terms and is not expressly limited just to the type of situation in question. To confine the case only to bills and notes would be putting words in the Court's mouth. In fact, as the majority stated that the matching principle is embodied in the statutory formula, it could be argued that the matching principle now applies in all section 51(1) cases. This interpretation lies at the other end of the spectrum.

Such an interpretation would, however, be entirely inconsistent with all previous section 51(1) cases. It is unlikely that the High Court meant to turn all previous authority on its head without acknowledging it. And it is certain that if the matching principle was to apply in all cases, then substantial hardships would result on taxpayers. For each loss or outgoing incurred, an inquiry would have to be made into the benefits arising from such expenditure. For example, under this approach the matching principle would apply to prepaid expenses. A prepayment is payment in respect of goods and services to be

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23 Id at 4228.

24 Richards, R, "Coles Myer Finance and the 'reasonably arguable' test" (1993) *Butterworths Weekly Tax Bulletin* 374.

25 Id at 374.

26 Above n1 at 4223.

27 In the *Coles Myer Finance* example, this method would treat the difference between the issue price of the bills and notes and the value of the bills and notes as at 30 June 1984 as deductible in the 1984 year of income. The remainder of the discount would be deductible in the following year.

provided (in full or in part) in the future. Examples would be payments in advance for rent, interest and insurance. Currently such expenses are deductible when paid, even though the benefits may occur in other periods.[28] Application of the matching principle to these situations would implicitly overrule many cases and would place heavy burdens on taxpayers.[29] Other strange results may happen. For example, if the income is derived in a year prior to that in which the expense is incurred, presumably the deduction would be lost. The expense would be incurred in the later year but would not be referable to it. Such a result would be contrary to a line of cases stretching from *Herald & Weekly Times Ltd*[30] *v FCT* to *Fletcher v FCT*.[31] In addition, in many cases the statutory de facto matching principle will apply anyway. Whenever payment is due at least 13 months after the expenditure is incurred, section 82KZM operates to spread the deduction evenly over the period from incurring to payment. Thus it is likely that the remaining question will only invoke something akin to the matching principle in limited cases.

B. Woolcombers (WA) Pty Ltd v FCT

This analysis suggests that some interpretation in between these two extremes is the correct one. One such interpretation was given by Lee J in *Woolcombers (WA) Pty Ltd v FCT*.[32] In this case the taxpayer, a wool trader, made contracts with woolgrowers to purchase wool yet to be shorn (forward contracts). In relation to the 1988 income year, the taxpayer estimated its liability to woolgrowers under forward contracts as at 30 June 1988 to be $56,254,140. The taxpayer did not earn income in the 1988 year of income from resale of wool it was entitled to receive under the forward contracts or by the sale of its interests in those contracts. The taxpayer claimed that its liability under the forward contracts was an allowable deduction under section 51(1) of the Act.

Lee J found that, at 30 June 1988, there was a "present liability imposed on the taxpayer by a definite contractual commitment".[33] Thus this was an outgoing incurred in the 1988 year of income as a matter of jurisprudential analysis. The question remaining was whether the outgoing incurred was "properly referable" to the 1988 year of income. On this point Lee J acknowledged that "the use by the taxpayer of the wool to be brought into stock under the forward contracts and the gaining of income therefrom would occur in the 1989 income year",[34] and that in 1988, no "revenue ingoing was available to be matched against the outgoing".[35] Thus the matching principle would suggest that the outgoing was not deductible in the 1988 year of income. However, Lee J thought that a loss or outgoing would always be properly referable to the year in which it was incurred unless the deduction sought was "an anomalous

28 See the long list of cases cited in the draft taxation ruling TR 93/D39.

29 Even the Commissioner of Taxation agrees that *Coles Myer Finance* does not apply to prepaid expenses: Ibid.

30 (1932) 48 CLR 113.

31 91 ATC 4950. See Slater, A, "The Coles Myer Decision" (1993) 15 *Aust Fed Tax Rep Tax Focus* 1.

32 (1993) 114 ALR 647.

33 Id at 655.

34 Id at 657.

35 Ibid.

event in the revenue operations of the taxpayer calculated to distort those operations by inflation of allowable deductions".[36] While the effect of allowing a deduction in the 1988 year of income of approximately $56 million in this case would be distortionary,[37] nevertheless it was allowed because it was part of the taxpayer's usual revenue operations. His Honour's approach therefore seems to assert that two criteria must be met in order for a loss or outgoing not to be properly referable to the year in which it is incurred:

(i) The transaction must be "anomalous", that is, outside the taxpayers usual operations; and

(ii) the transaction must distort the taxpayers operations by inflation of allowable deductions.

This formulation is doubtful for two reasons. First, the majority in *Coles Myer Finance* did not say that the actual transactions before them would cause distortion. This will be discussed later. Secondly, and most importantly, this approach is hardly compatible with the *Coles Myer Finance* decision itself. One would have thought that issuing bills of exchange and promissory notes is a very normal part of a financing company's activities.

Dissatisfied with Lee J's decision, the Commissioner appealed unsuccessfully to the Full Federal Court.[38] Beaumont, French and Foster JJ broke the inquiry into three questions. The first two are easily recognised: (1) was there an accrued obligation or present liability imposed by a definite contractual commitment?; and (2) if so, was an outgoing incurred in the 1988 year of income? Their third question is more debatable: (3) was an apportionment necessary or appropriate? In answer to this, the Court stated that "no case for any apportionment has been made out by the Commissioner".[39] But this misses the point. It is certainly true that there could be no apportionment of the expense, which remained fixed from the time at which it was incurred. It was not an expense that accrued daily like interest does. However, the real question for determination was, as the High Court framed it, how much of the net loss or outgoing is referable to the year of income? In Woolcombers this meant that the outgoing was either not allowable in the 1988 year of income, not being properly referable or attributable to that year, or was allowable in full.[40] The High Court never limited their statement of principle to cases of apportionment.

While the Full Court's third question was seemingly inspired by *Coles Myer Finance*, they barely mentioned the case in their judgment. In their discussion of the principles applicable to section 51(1), they merely stated the facts of that case and quoted from some of the judgments without attempting to distil any definitive principle.[41] Later on in their joint judgment they explained that apportionment in *Coles Myer Finance* was justified because of the "special nature of

36 Ibid.

37 This deduction would convert a $2.1 million taxable income into a $54 million taxable loss.

38 *FCT v Woolcombers (WA) Pty Ltd* 93 ATC 5170.

39 Id at 5181.

40 See Lee J's remarks on this; above n32 at 657.

41 Id at 5178–5179.

the financing transaction".[42] They proffered no explanation of why the transaction in Coles Myer was "special" or deserving of apportionment.

The discussions of *Coles Myer Finance* in *Woolcombers*, both at first instance and on appeal thus leave much to be desired. In fairness, the majority in *Coles Myer Finance* did not do their Federal Court counterparts any favours, as the judgment is riddled with uncertainty and unanswered questions. Nevertheless, it is possible to come up with a more convincing statement of principle from the case. This is what I shall now attempt to do.

C. Nevill & Co Ltd v FCT

The majority's discussion of section 51(1) began, perhaps curiously, with a discussion of *W Nevill & Co Ltd v FCT*, a case referred to earlier. In *Coles Myer Finance* it was held unanimously that the liability to pay promissory notes is incurred when issued. However, the discount on promissory notes in *Nevill* was only deductible when the money was paid to the director, not when the notes were issued. The decision was thus similar to the situation in *Coles Myer Finance*. *Nevill* is an interesting case, as proper reasons were not given, and no one has ever really been able to explain the basis of the result. However, the majority in *Coles Myer Finance* explained that the decision in *Nevill* was based on the fact that:

> *[I]n the particular circumstances of that case*, the liability to make the payments was an outgoing *properly referable* to the years of income in which the payments were *made* rather than the year in which the liability to make the payments was actually *incurred*.[43] (emphasis added).

As stated previously, under the jurisprudential analysis of section 51 losses or outgoings are deductible in full in the year in which they are incurred. *Nevill* departed from this orthodoxy by holding that a deduction was allowable in a different year to that in which the loss or outgoing was incurred. Comprehensive reasons for this conclusion were not given at the time, but an explanation has now been supplied by the majority in *Coles Myer Finance*. There appear to be perhaps three factors, as indicated in the passage quoted above. First, the loss or outgoing must be incurred in one year of income, and payment must be made in a later year. This is a common feature of cases such as *Nevill*, *New Zealand Flax*, *AGC* and *Coles Myer Finance*. Secondly, the loss or outgoing must be properly referable to the year in which payment is made. This factor probably involves an application of the matching principle or something similar. Third, there may also need to be some other "particular circumstances" in order for the traditional result to be departed from. In *Coles Myer Finance*, the majority suggest[44] (quoting from *FCT v Ash*)[45] that the fact that the expenditure in *Nevill* was abnormal and irregular contributed to the result of that case.[46]

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42 Id at 5181.

43 Above n1 at 4220.

44 Ibid.

45 (1938) 61 CLR 263 at 282.

46 Also note that the *Coles Myer Finance* principle, as applied to *Nevill*, meant that the outgoings in that case were wholly deductible when paid, not incurred. There was no apportionment. This throws doubt on the validity of the third question posed by the Full

Support for this analysis is found when the majority, referring to the need for the remaining question in *Coles Myer Finance*, state:

> Although the legal liability to pay is *incurred* in the year of income, the amount in question is not *payable* until the subsequent year of income and, more importantly, the net loss or outgoing represents the cost of acquiring funds which the taxpayer puts to *profitable advantage* in both years of income.[47] (emphasis added).

This passage emphasises the need for the first two factors mentioned above, before the traditional result will be departed from.

D. Distortion

Later comments by the majority point to the reasons behind their stance. They justify their approach by the following example. Take the case of long term, ten year bills of exchange. The amount of discount in this case would be substantial. If the taxpayer were allowed a deduction for the whole amount of the discount in the year they were drawn, this would:

> [L]ead to a distortion of the taxpayer's operations on revenue account in the year of income in which the bills are drawn and would open the way to inflating very considerably the amount of allowable deductions under s. 51 for that year.[48]

The concern expressed in this passage is that of distorting operations, and the possibilities this allows for tax deferral. Note that the majority did not state that to allow the deduction in full in the 1984 year would be actually distortionary. Their concern was with the precedent that such a decision would set. This tax avoidance motive rests comfortably alongside other recent High Court tax decisions.[49] It also illustrates the correctness of the approach outlined above. Where an expense is incurred in one year and paid in another, this allows considerable scope for tax deferral. Much more so than the ordinary prepayment situation where the money is paid and incurred in the same period. This may suggest the "particular circumstances" in *Coles Myer Finance* that contributed to the result: that is, the type or character of the transaction in question had potential to distort. In most cases where the loss or outgoing is incurred in one year but paid for in another, there will be scope for distortion and tax deferral.

Latham CJ in *Nevill* recognised the fundamental problem addressed in *Coles Myer Finance*. He said:

> It is impossible to avoid the reflection that, if it were held that deductions could be obtained in any given year by the simple process of signing promissory notes in respect of genuine liabilities which would not fall due until that year

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Federal Court in *Woolcombers*.

47 Above n1 at 4222.

48 Id at 4222–3.

49 For example, *Fletcher v FCT* 91 ATC 4950; (1991) 173 CLR 1.

> had expired, a taxpayer would be able, by such action, to influence the rate of tax in his own favour. [50]

Coles Myer Finance is focused not just on deliberate tax avoidance though, but also on transactions which, under the traditional approach, allow scope for deferral advantages that are not justified on the basis of commercial reality.

5. *Conclusion*

This controversial and much talked about decision has created quite a stir in professional and academic circles. This note has proposed one interpretation which, it is hoped, is fairly consistent with the text of the case. Under the approach outlined, the case explains several earlier decisions, without overruling previous authorities. It continues the trend of the High Court in taking a more pragmatic approach to the *Income Tax Assessment Act*, but without making taxpayers subject to the matching principle in most cases. However, the extent of the case will not truly be known until we receive at least one, but probably several, High Court decisions explaining the consequences of *Coles Myer Finance*.

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50 Above n9 at 302–303.

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