LEGAL EXPENSES AS NON-DEDUCTIBLE CAPITAL EXPENDITURE
COMMISSIONER OF TAXATION v. *SNOWDEN & WILLSON PTY. LTD.*
JOHN FAIRFAX & SONS PTY. LTD. v. *COMMISSIONER OF TAXATION*

The Income Tax and Social Services Contribution Assessment Act 1936-1958 (Cwlth.)[1] is, of course, directed to the assessment of "*income*"[2] as a criterion of tax liability and does not, in the main, attempt to subject to income tax profits and receipts which are of a capital nature.[3] A correlative principle is embodied in s.51 which is the general and by far the most important section of the Act relating to allowable deductions. Under s.51[4] a deduction is specifically denied in respect of any loss or outgoing which is of a capital nature and which might otherwise have qualified as a deduction under that section.[5]

The most fundamental and constantly recurring problem in the field of income tax law is, therefore, to distinguish, both for purposes of assessability and deductibility, items of a capital nature from items of an income or revenue nature. The difficulty is aggravated by the understandable and, perhaps, inevitable omission from the Act of any general definition of those concepts,[6] which, being essentially commercial terms, have their origin in economic and accounting usage rather than in legal theory.[7]

I. *Capital or Income? Varying Tests*

Deductibility under s.51 will always depend upon the following separate but related questions,[8] the first of which must be capable of being answered in the affirmative and the second in the negative:

1. Was the expenditure an outgoing incurred in gaining, or necessarily incurred in carrying on business for the purpose of gaining, assessable income? And, if so,
2. Was it an outgoing of a capital nature?

The problem posed by the second question is the one with which this

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[1] No. 27, 1936—No. 55, 1958. [2] *Id.* s.26.

[3] Certain specific provisions of the Act constitute exceptions to the basic principle; these include ss.36(1), 59(2), 84.

[4] Section 51 is in the following terms:

(1.) All losses and outgoings to the extent to which they are incurred in gaining or producing the assessable income, or are necessarily incurred in carrying on a business for the purpose of gaining or producing such income, shall be allowable deductions except to the extent to which they are losses or outgoings of capital, or of a capital, private or domestic nature, or are incurred in relation to the gaining or production of exempt income.

(2.) Expenditure incurred or deemed to have been incurred in the purchase of stock used by the taxpayer as trading stock shall be deemed not to be an outgoing of capital or of a capital nature.

[5] Certain specific kinds of capital losses or expenditure are allowable deductions under particular provisions in other sections of the Act, e.g. ss.59(1), 85.

[6] The difficulty in formulating precise definitions of these terms is reflected in the fact that similar omissions occur in corresponding legislation of many other countries, including the United Kingdom, New Zealand, Canada and the United States.

[7] See *Hallstroms Pty. Ltd.* v. *Commissioner of Taxation* (1946) 72 C.L.R. 634, 646, *per* Dixon, J.

[8] *John Fairfax & Sons Pty. Ltd.* v. *Commissioner of Taxation* (1959) 32 A.L.J.R. 370, 375, *per* Menzies, J.

Note is primarily concerned. Basically it is a question of characterisation and to the extent to which the expenditure may be found to be of a capital nature, and this may necessitate an apportionment,[9] it must be disallowed. The difficulties involved are highlighted by a consideration of the deductibility of legal expenses incurred in the conduct of a business. Such expenditure frequently falls within the marginal zone between what is clearly capital on the one hand and what is clearly revenue on the other, and has been the subject of two recent decisions of the Full High Court of Australia in *Commissioner of Taxation* v. *Snowden & Willson Pty. Ltd.*[10] and *John Fairfax & Sons Pty. Ltd.* v. *Commissioner of Taxation*,[11] which clearly illustrate the supreme importance of the capital-revenue distinction as the final determinant of deductibility under s.51. In both of those cases the High Court has reiterated disapproval which it had previously expressed[12] of the more liberal approach adopted by Lawrence, J. in *Southern* v. *Borax Consolidated Ltd.*,[13] in relation to corresponding provisions of the Income Tax Act, 1918 (Eng.),[14] despite the fact that in the interim that decision has been followed in two English cases,[15] including one decided by the Court of Appeal, and appears to have been approved by the House of Lords in *Morgan* v. *Tate & Lyle Ltd.*[16]

The most favoured of the numerous tests[17] proposed for distinguishing capital expenditure from revenue expenditure has been that propounded by Viscount Cave, L.C. in *British Insulated & Helsby Cables Ltd.* v. *Atherton.*[18] After referring to the rough criterion suggested by Lord Dunedin in *Vallambrosa Rubber Company Ltd.* v. *Farmer (Surveyor of Taxes)*[19] 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", Viscount Cave went on to say:

> But when an expenditure is made, not only once and for all, but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade, I think there is good reason (in the absence of special circumstances leading to an opposite conclusion) for treating such expenditure as properly attributable not to revenue but to capital.

However, it appears that in relation to s.51 the trend of recent High Court decisions indicates that the "enduring benefit" test has been subsumed by principles first expounded by Dixon, J., as he then was, in *Sun Newspapers Ltd.* v. *Commissioner of Taxation.*[20] In that case it was held that a sum paid by a newspaper company to eliminate a business competitor was capital expenditure. His Honour said that "Recurrence is not a test, it is no more than a

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[9] *Id.* at 371, *per* Dixon, C.J.

[10] (1958) 32 A.L.J.R. 167.

[11] (1959) 32 A.L.J.R. 370.

[12] *Broken Hill Theatres Ltd.* v. *Commissioner of Taxation* (1952) 85 C.L.R. 423, 434, where four of the five justices approved the earlier criticism by Dixon, J. in *Hallstroms' Case* (1946) 72 C.L.R. 634, 650-51.

[13] (1941) 1 K.B. 111.

[14] Broadly the position under this Act was that tax was charged on "annual profits or gains" arising from any trade, profession, employment or vocation (Schedule D, para. 1(a)(ii)). Rules 1 and 3 to Cases I and II of Schedule D provided: In computing the amount of the profits or gains to be charged no sum shall be deducted in respect of— (a) any disbursements or expenses, not being money wholly and exclusively laid out or expended for the purpose of the trade . . . (b) any capital withdrawn from or any sum employed or intended to be employed as capital in such trade. . . ." See now s.137 of the Income Tax Act, 1952 (Eng.), which repeals, and consolidates without amendment the 1918 Act and other relevant statutes.

[15] *Associated Portland Cement Manufacturers Ltd.* v. *I.R.C.* (1946) 1 All E.R. 68, 72 (C.A.), *per* Lord Greene, M.R.; *Cooke* v. *Quick Shoe Repair Service* (1949) 30 T.C. 460 (Croom-Johnson, J.).

[16] (1955) A.C. 21, *per* Lords Morton and Asquith at 41 and 46, Lord Reid at 51, Lord Tucker at 62 and Lord Keith at 69.

[17] Other suggested tests are discussed in J. P. Hannan, *Principles of Income Taxation* (1946) cc. 26-29.

[18] (1926) A.C. 205, 213-214.

[19] (1910) 5 T.C. 529, 536.

[20] (1938) 61 C.L.R. 337, 359-361.

consideration the weight of which depends upon the nature of the expenditure"[21] and that the ideas of recurrence and endurance both depend on degree and comparison. In his view the "enduring benefit" formula was one that should receive an elastic application after a consideration of (1) the character of the advantage sought to be achieved by the expenditure, (2) the manner in which that advantage is to be used, and (3) the means adopted to obtain it. These factors, however, seem to have been conceived as mere *indicia* for purposes of applying his Honour's own conceptual approach to the problem as embodied in what may be regarded as a general test formulated as follows:

> The distinction between expenditure and outgoings on revenue account and on capital account corresponds with the distinction between the business entity, structure or organization set up or established for the earning of profit and the process by which such an organization operates to obtain regular returns by means of regular outlay, the difference between the outlay and returns representing profit or loss.[22]

It was, however, largely in reliance upon Viscount Cave's test that, in the *Borax Case*,[23] Lawrence, J. held that a company was entitled to a deduction for legal expenses incurred in defending its title to land which it had purchased six years earlier for use in its business. In holding that the expenditure was not of a capital nature, his Honour said:

> In my opinion, the principle which is to be deduced from the cases is that where a sum of money is laid out for the acquisition or the improvement of a fixed capital asset, it is attributable to capital, but that if no alteration is made in the fixed capital asset by the payment then it is properly attributable to revenue, being in substance a matter of maintenance, the maintenance of the capital structure or the capital assets of the company. . . .[24]
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> It appears to me that the legal expenses did not create any new asset at all, but were expenses which were incurred in the ordinary course of maintaining the assets of the company, and the fact that it was maintaining its title and not the value of the company's business does not, in my opinion, make it any different.[25]

This decision, in effect, treats the converse of Viscount Cave's test as a conclusive discrimen of capital expenditure, with its corollary that expenditure which does not result in the acquisition or improvement of a capital asset but is directed merely to the maintenance, preservation or protection of existing assets is not of a capital nature. In *Associated Portland Cement Manufacturers Ltd.* v. *Kerr*[26] it was applied with approval by Lord Greene, M.R. who said: "The money you spend in defending your title to a capital asset which is assailed unjustly is obviously a revenue expenditure." Again, it was cited with approval by Latham, C.J. and Williams, J., two of the majority in *Hallstroms' Case*,[27] in allowing a deduction under s.51 for legal costs incurred in successfully opposing a competitor's application for an extension of a patent on an invention which the taxpayer, in anticipation of the patent's expiry, was planning to incorporate in the manufacture of its products. On the other hand, Dixon, J., with whom McTiernan, J. agreed, in a vigorous dissenting judgment[28] in which he applied the principles which he had formulated in the *Sun Newspapers Case*, condemned the decision in the *Borax Case* as fallacious both logically and on principle, mainly on the ground that Viscount Cave's test was not intended to be an exhaustive one either in its positive or its

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[21] *Id.* at 362.
[22] *Id.* at 359.
[23] *Southern* v. *Borax Consolidated Ltd.* (1941) 1 K.B. 111.
[24] *Id.* at 116-17.
[25] *Id.* at 120.
[26] (1946) 1 All E.R. 68, 72.
[27] *Hallstroms Pty. Ltd.* v. *Commissioner of Taxation* (1946) 72 C.L.R. 634, 642, 655.
[28] *Id.* at 645.

negative application. It is this view which has prevailed in the later decisions of the High Court.

The *Borax Case* was unsuccessfully relied upon in *Broken Hill Theatres Pty. Ltd.* v. *Federal Commissioner of Taxation*,[29] where a deduction was disallowed for legal expenses incurred by a motion picture exhibitor in opposing an application by a potential competitor for a licence to establish a theatre in the town where the taxpayer was operating. The taxpayer had consistently opposed several previous applications with the object of maintaining box-office takings and avoiding increased expenditure on film hire and advertising. Notwithstanding the finding that the legal expenses were incurred in gaining or producing the assessable income and that the expenditure was appropriate or adapted for that purpose, it was held unanimously by the Full High Court[30] that essentially the expenditure was incurred "for the purpose of preserving and protecting the company's business"[31] by restricting competition and, therefore, it was of a capital nature. The contentions for the taxpayer that the expenditure was of a revenue nature because it resulted in no new asset or right being brought into existence and was recurrent in type were held not to be conclusive of the question and four justices approved the views expressed by Dixon, J. in *Hallstroms' Case* that the decision in the *Borax Case* was unsupportable.

The capital nature of expenditure made for the purpose of preserving and protecting the taxpayer's business was restated by Taylor, J. in the *Duro Case*[32] when he said that the principle applied to expenditure made "solely to protect an existing asset." However, his Honour found that the expenditure there in question, namely legal and other costs incurred by a taxpayer in settling disputes with competitors who were allegedly infringing its trade mark by the use of similar marks, did not fall within that category since no attack had been made upon the validity of the taxpayer's existing rights which remained precisely as they were before. His Honour concluded that the expenditure, which resulted in inducing the competitors to cease the user complained of, was incurred in exploiting existing rights in the course of the profit-yielding process rather than in the preservation of the profit-yielding subject. With respect, it is suggested that the more realistic view would have been to regard the expenditure as incurred for the purpose of ensuring the continuance of the taxpayer's right to a monopoly of the mark and freedom from competition in its user. In this view it would clearly have been incurred in the protection or preservation of the value of the asset and the case would hardly be distinguishable from the *Broken Hill Theatres Case.*

II. *The Impact of Morgan* v. *Tate & Lyle Ltd.*

This, then, was the stage reached in the High Court's interpretation of the meaning of capital expenditure for purposes of s.51, when the House of Lords in *Morgan* v. *Tate & Lyle Ltd.*[33] decided by majority that there was no reason in law why the cost of a propaganda campaign undertaken by a company engaged in an industry threatened by nationalisation should not be deductible. The decision was based on the fact that the object of the expenditure was to

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[29] (1952) 85 C.L.R. 423.

[30] Dixon, C.J.; McTiernan, Webb, Fullagar and Kitto, JJ., affirming the decision of Williams, J.

[31] *Id.* at 433-34.

[32] *Federal Commissioner of Taxation* v. *Duro Travel Goods Pty. Ltd.* (1953) 87 C.L.R. 524, 527.

[33] (1955) A.C. 21.

enable the taxpayer to preserve its assets from seizure and to enable it to continue to earn profits. This factor was held to be a sufficient compliance with the rule that the expenditure must be "wholly and exclusively laid out for the purposes of the trade." As indicated above,[34] the *Borax Case* was cited with apparent approval by all of their Lordships. Lord Morton, with whom Lord Asquith agreed, expressed his agreement with the "well settled" view that the balance of profits and gains chargeable to tax must be ascertained in accordance with commercial principles by deducting from gross receipts all expenditure properly deductible on those principles, except those specifically precluded by the statutory prohibitions in the rules. The types of capital expenditure referred to in the rules appear to be limited in scope, but nevertheless it has long been settled that capital expenditure is necessarily excluded on commercial principles and is never allowable as a deduction in ascertaining the balance of profits or gains. It was for this reason that the expenditure in question in *British Insulated & Helsby Cables* v. *Atherton*[35] was held not to be deductible even though wholly and exclusively laid out or expended for the purpose of the trade.

It is considered that the main issue in the *Tate & Lyle Case* was not whether the expenditure was of a capital nature but whether it was wholly and exclusively laid out for the purposes of the trade. To this extent it was more directly concerned with problems arising under the first rather than the second of the two main questions upon which deductibility under s.51 depends. This seems to be true also of the decision of the Privy Council in *Ward's Case*[36] where it was held that the cost of an anti-prohibition campaign by a brewery company was not deductible, being expenditure "not exclusively incurred in the production of assessable income" within the meaning of the exclusion clause in those terms in s.86(1)(a) of the Land and Income Tax Act 1916 of New Zealand. In its judgment the Privy Council described the expenditure as "a voluntary expense incurred with a view to influencing public opinion against taking a step which would have depreciated and partly destroyed the profit-bearing thing",[37] and as not being necessary for the production of profit nor in fact incurred for that purpose. The majority of their Lordships in *Tate & Lyle's Case* was able to distinguish that decision on the ground that the provisions of the N.Z. Act were narrower than the corresponding provisions of the U.K. Act. A similar distinction was later to be employed by the High Court in *Fairfax's Case* in distinguishing *Tate & Lyle's Case* on the question of what constitutes capital expenditure as well as on other aspects of s.51.

Nevertheless, it is submitted that the decision in *Tate & Lyle's Case* that there was no reason in law precluding a finding that the expenditure was wholly and exclusively laid out for the purposes of the trade necessarily implied that it was not of a capital nature. As indicated above, this question is so inextricably linked under the U.K. provisions with the question whether the expenditure was so wholly and exclusively laid out as, in effect, to constitute a single question instead of the two separate questions which arise under s.51. It is true that Lord Morton stated that the appellant "did not contend that the expenditure was of a capital nature but relied solely upon the prohibition in rule 3(a). . . ."[38] However, the non-deductibility of capital expenditure was referred to and assumed as axiomatic in argument for both parties.[39] This principle was referred to obliquely by Lord Reid[40] and more directly by the

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[34] *Supra* n. 16.
[35] (1926) A.C. 205. See also *Commissioner of Taxation* v. *Snowden & Willson Pty. Ltd.* (1958) 32 A.L.J.R. 167, 171, *per* Fullagar, J.
[36] (1923) A.C. 145.
[37] *Id.* at 149.
[38] (1955) A.C. 21, 39.
[39] *Id.* at 24, 26, 27, 34 and 35.
[40] *Id.* at 51.

two dissentients, Lord Tucker[41] and Lord Keith.[42] If, as is submitted, the decision in this case necessarily involved a finding that the expenditure was not of a capital nature, this raises the important question whether the High Court in *Fairfax's Case* was justified in distinguishing the case not only on the first question arising under s.51 but also on the second.

In *Commissioner of Taxation* v. *Snowden & Willson Pty. Ltd.*,[43] the High Court held by a four to one majority that the taxpayer, whose business included speculative building, was entitled to a deduction under s.51 for the cost of legal representation before a Royal Commission appointed to inquire into allegations that it had engaged in dishonest business practices and for the cost of advertising and similar expenditure in an attempt to refute those allegations. The majority found that the expenditure was necessarily incurred in carrying on business for the purpose of gaining or producing assessable income[44] and was not of a capital nature.

It was unsuccessfully contended for the Commissioner that the expenditure was made for the preservation of the company's goodwill and was therefore of a capital nature on the authority of the *Broken Hill Theatres Case.* In considering what was the essential purpose of the expenditure, all members of the Court seem to have reached the conclusion, directly or indirectly, that it was either wholly or partly incurred in the defence of goodwill. Webb, J., in dissent, accepted the express evidence of the managing director to that effect and found that it was decisive against deductibility.[45] Dixon, C.J. found that the company, if it was to sustain its volume of business, had no alternative but to defend itself from attacks "calculated to deter intending or likely customers from dealing with it and to destroy the faith of existing customers in their current relations with the company."[46] As goodwill is essentially the capitalised value of future profits, one of its important constituent elements being the likelihood that customers will continue to patronise the business,[47] his Honour's statement appears to be tantamount to a recognition that the expenditure was in fact incurred in defence of goodwill. Fullagar, J., with whom Williams, J. agreed, conceded[48] that the expenditure was incurred partly to preserve goodwill and partly as an indirect means of forestalling possible claims for reduction in liabilities owing by contractors and mortgagors who stood in an existing legal relationship to the company. And Taylor, J. remarked: "No one would . . . deny that if the respondent had made no attempt to combat the allegations . . . it would have been highly probable that its goodwill would have suffered."[49]

However, Fullagar, Williams and Taylor, JJ. distinguished the *Broken Hill Theatres Case* as one involving a payment to secure freedom from competition.[50] Taylor, J. added that in his opinion the fact that goodwill would or

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[41] *Id.* at 62. [42] *Id.* at 67, 68, 69, 70 and 71. [43] (1958) 32 A.L.J.R. 167.

[44] The Court considered that the first and second limbs of the first condition precedent to allowance of a deduction under s.51 were not mutually exclusive although the second limb added little to the first. The case is also of interest because of the clarification made of the meaning of the word "necessarily". "Logical necessity is not a thing to be predicated of business expenditure. What is meant is that the expenditure must be dictated by the business ends to which it is directed, those ends forming part of or being truly incidental to the business." (*Per* Dixon, C.J. at 168.) "The meaning of the word . . . is not limited to compulsion in a legal sense and extends to business expenditure arising out of exigencies created by unusual or difficult circumstances." (*Per* Fullagar, J. at 171 adapting and adopting views expressed in Hannan, *op. cit.* (1946) *supra* n. 17 at 291.)

[45] (1958) 32 A.L.J.R. 167, 169. Although he stated that he was applying the reasoning in the *Broken Hill Theatres Case*, his Honour, in stressing that the expenditure was not *directly* incurred in gaining or producing the assessable income seems to have twisted that decision to represent it as an authority on the first rather than the second question arising under s.51.

[46] *Id.* at 168. [47] See *infra* n. 52.

[48] (1958) 32 A.L.J.R. 167, 172. [49] *Id.* at 174.

[50] The writer suggests that freedom from competition is a factor, and frequently a major factor, in determining the existence and value of goodwill.

might suffer was not of itself sufficient to brand the expenditure as being of a capital nature. Dixon, C.J. did not specifically deal with this aspect of the Commissioner's case, being content to conclude that there was "no satisfactory ground for saying that the expenditure was an affair of capital."[51]

As goodwill is undoubtedly classifiable as a capital asset,[52] there appears to be a curious inconsistency between the decision in this case and the strong position taken in other cases by the High Court, in the face of the contrary English decisions referred to above, that legal expenses incurred in the protection or preservation of a capital asset are expenditure of a capital nature. Unless an exception is to be made from this principle in favour of legal expenses in defence of goodwill, it is difficult to appreciate why an apportionment between capital and revenue was not considered necessary to disallow at least so much of the expenditure as was attributable to the protection of that asset. Such an apportionment is clearly authorised, and, indeed, required by s.51 in the case of an outgoing which is in part of a capital nature and in part of a revenue nature.[53]

The Commissioner also failed in his contention that because the company was defending itself against charges of fraud it was disentitled to a deduction by analogy to cases where penalties and costs incurred in connection with prosecutions for infringements of the law have been held not to be deductible. The *rationale* of those cases has usually been expressed as being that the nature of the expenditure severs it from the purposes of trading, being inflicted and incurred by way of punishment as a personal deterrent and not incurred in the character of trader. Frequently this line of reasoning has appeared in relation to the facts to be strained and artificial, giving rise to anomalous results.[54] It is suggested that the only real justification for the existence of such a general rule is to be found in rather dubious considerations of public policy. Perhaps the instant case, and particularly *dicta* of Webb, J.,[55] is indicative of a growing appreciation of the anomalies inherent in a rigid application of the rule and of an attempt to confine it to cases of penalties resulting from convictions on criminal or quasi-criminal charges.

III. *"Profit-Yielding Process" as a Test?*

In *John Fairfax & Sons Pty. Ltd.* v. *Commissioner of Taxation*,[56] the Full High Court unanimously upheld the disallowance of a deduction for legal expenses incurred by the appellant, a newspaper company, in the course of a struggle with a second newspaper company, Consolidated Press Ltd., for control of a third such company, Associated Newspapers Ltd. As a first step in what

[51] (1958) 32 A.L.J.R. 167, 168.

[52] "The goodwill of a business is an asset of the business and is plainly a capital asset", *Sun Newspapers Ltd.* v. *Federal Commissioner of Taxation* (1938) 61 C.L.R. 337, 356, *per* Latham, C.J. See also the cases there cited and Dixon, J's. description of goodwill as "widespread or general reputation, habitual patronage by clients or customers and an organized method of servicing their needs." *Id.* at 360.

[53] *Texas Company (A'sia) Ltd.* v. *Federal Commissioner of Taxation* (1940) 63 C.L.R. 382, 466, *per* Dixon, J.: *Ronpibon Tin N.L.* v. *Federal Commissioner of Taxation* (1949) 78 C.L.R. 47, 55, 59-60; *John Fairfax & Sons Pty. Ltd.* v. *Commissioner of Taxation* (1959) 32 A.L.J.R. 370, 371.

[54] Surely it is unreal to contend that the fines which are almost an inevitable incident of an illegal business such as starting-price bookmaking are not incurred in the course of carrying on that business. It is anomalous that a taxpayer should be assessable on his income from that source but denied a deduction for fines paid.

[55] (1958) 32 A.L.J.R. 167, 169-170 where his Honour suggested the possibility that an employer might be entitled to a deduction for money paid in defence of employees who commit breaches of the law in the course of their employment and referred particularly to traffic breaches.

[56] (1959) 32 A.L.J.R. 370.

ultimately was to develop into a complete take-over, the directors of Associated accepted Fairfax's offer to purchase the whole of the company's unissued share capital and the shares were allotted and issued accordingly. The substantial influence in the policy, control and business of Associated which the voting rights attached to those shares thus secured to Fairfax later ripened into a position of complete control and this development was probably envisaged by all of the parties from the outset. Later on the day in which the shares were issued a suit in Equity was commenced on behalf of Consolidated seeking a declaration that the allotment was void. The suit was eventually withdrawn by consent but involved Fairfax in legal expenses of over £3,000.

The main judgments in the High Court were delivered separately by Fullagar, J. and Menzies, J., the other members of the Court concurring. The Court decided that the expenditure did not satisfy the first of the two main conditions precedent to deductibility under s.51 despite an attempt by the appellant to link the outgoing in its Profit and Loss Account with specific items of income which resulted from certain interim working arrangements entered into with Associated as integral parts of the overall plan for a merger of publishing operations of the two companies. Menzies, J. considered that the acquisition and defence of the shares merely put the appellant in a position to enter into partnership with Associated and, therefore, the expenditure was incurred in the course of *extending* its business rather than in the *carrying on* of its business. For this reason it was not a working expense and therefore not deductible. On this aspect his Honour said:

> To make a payment to acquire or to defend the acquisition of a favourable position from which to earn income or to enter into arrangements that will yield income is not in general an outlay incurred either in gaining or in carrying on business for the purpose of gaining assessable income; such a payment in the case of a trading company, occurs at a stage too remote from the receipt of income to be so regarded. To be deductible an outlay must be part of the cost of trading operations to produce income, i.e. it must have the character of a working expense.[57]

It was also held that in any event the expenditure was of a capital nature. Strictly, however, this was not essential to the decision having regard to the finding on the first question. On this point the main argument for the taxpayer was that at the time the suit was commenced it had actually become the owner of a new asset consisting of a large number of shares: the suit was an attack upon its title to that asset and, on the authority of the *Borax Case*, as approved in the subsequent English cases, the cost of defence was of a revenue and not of a capital nature. As already mentioned, this contention failed,[58] the Court refusing to reconsider its previous disapproval of the *Borax Case*. Fullagar, J. advanced an additional and convincing reason why the *Borax Case* should not be followed by distinguishing it on the facts:

> This is not . . . a simple case of expenditure incurred by the taxpayer in order to prevent its being deprived of an asset owned or possessed by it. If one looks at the substance of the matter, it would accord much more

[57] *Id.* at 376-377.

[58] On this point the High Court decisions are in line with decision of Courts of Appeals of the United States on statutory provisions corresponding to s.51 (currently s.162 of U.S. Internal Revenue Code of 1954 which permits a deduction for all "ordinary and necessary" expenses paid or incurred in carrying on any trade or business). The U.S. case law has, however, been fortified since 1916 by a Treasury Regulation, Art. 24-2, Reg. 86, which provides: "The cost of defending or perfecting a title to property constitutes part of the cost of the property and is not a deductible expense." (See, e.g., *Safety Tube Corporation* v. *Com'r.*, 168 F. 2d 787.) Nevertheless, a deduction is allowable if the litigation was mainly directed to the conduct of the business, the question of title being only incidental (*Hochschild* v. *Com'r.* 161 F. 2d 817; *Levett & Sons* v. *Nunan* 142 F. 2d 795). In several respects the decision in the latter case is very similar to that in *Snowden & Willson's Case.*

> with reality to describe that expenditure as incurred in the course of, and as incidental to, the acquisition of a new asset. . . . The lawsuit was an incident of the competition for control, and the costs of defending it were an incident of one step in that competition—the acquisition of the unissued shares. They were really part of the cost of acquiring the shares.[59]

In other words, his Honour looked beyond the mere form and date of the expenditure as being in defence of a title already acquired, to its real substance as an inevitably concomitant incident in the acquisition of that title and the ultimate merger. Perhaps a similar approach is implicit in the following extract from the judgment of Dixon, C.J.:

> I regard the litigation as exclusively concerned with the organization and structure of the profit-earning enterprise. In point of fact the litigation formed part, an inseverable part, of the contest over the so-called merger. To my mind it would not matter if the suit had been instituted only as an attack on a title to shares after the title had been acquired. For not only was it an inseverable part of the main transaction but in any case such an attack necessarily concerned a matter of capital.[60]

Nevertheless, legally the title had been validly acquired and it may be questioned whether this approach represents an attempt to apply the old doctrine of substance as against form which, it appears, can no longer be invoked for the purpose of treating a transaction of one legal character as though it were a transaction of a different legal character.[61] Perhaps the following remarks of Lord Greene, M.R. are apt to describe such an approach:

> The argument, so far as it deals with the facts of the present case is . . . nothing but an attempt to revive the "supposed doctrine" of substance and form. That argument, one had hoped, had been decently interred by the decision (of the House of Lords) in *Commissioners of Inland Revenue* v. *Duke of Westminster*. However, its ghost still walks on occasions; and this, it appears to me, is one of them.[62]

Although *Fairfax's Case* is an extreme one, it may be possible to argue that the alternative approach of Fullagar, J. to the question of capital expenditure is not opposed to the principle of the *Duke of Westminster's Case* on the ground that that principle applies only to the characterisation of receipts in the hands of the payee and does not preclude an examination of the substance of the expenditure so far as the payor is concerned.[63] Indeed, the same approach seems to have been advocated by Dixon, J. in *Hallstroms' Case* where his Honour said: "What is an outgoing of capital and what is an outgoing on account of revenue depends on what the expenditure is calculated to effect from a practical and business point of view, rather than upon the juristic classification of the legal rights, if any, secured, employed or exhausted in the process."[64]

IV. *The High Court's View of "Capital Expenditure": An Evaluation*

Fairfax's Case establishes beyond doubt that the High Court is implacably opposed to the trend of English decisions stemming from the *Borax Case,* and indicates that Viscount Cave's test of capital expenditure is regarded as subsidiary to the principles expounded by Dixon, J. in the *Sun Newspapers Case;* whilst in its positive application Viscount Cave's test may be invoked to brand expenditure as being of a capital nature, its application with the opposed

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[59] (1959) 32 A.L.J.R. 370, 374. [60] *Id.* at 372.
[61] *Commissioners of Inland Revenue* v. *Duke of Westminster* (1936) A.C. 1.
[62] *Craddock* v. *Zevo Finance Co. Ltd.* (1944) 1 All E.R. 566, 571 (C.A.).
[63] See *per* Fullagar, J. in *Colonial Mutual Life Assurance Society Ltd.* v. *Commissioner of Taxation* (1953) 89 C.L.R. 428, 454-457, 459.
[64] (1946) 72 C.L.R. 634, 648.

results cannot be relied upon to any extent as an indicator of revenue expenditure.

In the writer's opinion there appears to be a measure of inconsistency in the reasons given for the various High Court decisions referred to.[65] It seems difficult to reconcile on any broad principle the decisions in *Hallstroms' Case,* the *Duro Case* and *Snowden & Willson's Case,* with the decisions in the *Broken Hill Theatres Case* and *Fairfax's Case,* unless an exception to the rule that legal expenses incurred in the protection or preservation of capital assets are capital in nature is to be admitted in favour of expenses in defence of intangible capital assets such as goodwill, patents and trade marks.[66] The exception would itself have to be subject to an exception in cases such as the *Broken Hill Theatres Case* where the expenditure results in competition being eliminated or stultified.

Notwithstanding the difficulty in discerning any readily identifiable general policy underlying the High Court decisions, it must be admitted that from a practical business viewpoint the results of the cases, with the possible exception of *Hallstroms' Case,* seem to be satisfactory. In those cases in which taxpayers have been successful, the legal expenses in issue have been capable, to a greater or lesser extent, of being fairly classified, in an indefinable way, as "working", "operating" or "trading" expenses, and it is this factor which appears to have tipped the scales in favour of deductibility. Perhaps the truth of the matter is that it is impossible to formulate any general test of capital expenditure capable of ready and certain application in all cases and that essentially the decisions represent value judgments depending primarily on the judge's assessment of the facts of each case tested against his own inherent conception of what is and is not capital expenditure. If this be true, the numerous "tests" referred to in the authorities can none of them be relied on with confidence as decisive of cases of any novelty. In borderline cases it may well be that certain remarks of Lord Greene, M.R. in *Inland Revenue Commissioners* v. *British Salmson Aero Engines Ltd.* correctly summarise the actual position, though it would be presumptuous of this writer to adopt them. Lord Greene, M.R. said "Indeed, in many cases it is almost true to say that the spin of a coin would decide the matter almost as satisfactorily as an attempt to find reasons."[67]

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[65] R. E. O'Neill in "Expenditure in Protecting or Preserving Capital Assets" (1956) 29 *A.L.J.* 561, 565 also points out that legal expenses in protecting or preserving business assets do not seem to differ in kind from other expenditure directed to that purpose such as fire insurance, which appears to be deductible. The same is true of repairs by way of maintenance (see Hannan, *op. cit.* c. 34) which would probably be deductible under s.51 quite apart from the specific provisions of s.53; see *Usher's Wiltshire Brewery* v. *Bruce* (1915) A.C. 433.

[66] R. E. O'Neill, *op. cit. supra* n. 65, at 566, attempts to reconcile the *Broken Hill Theatre's Case* and *Hallstroms' Case* with each other and with authority on the basis that an enduring benefit for purposes of Viscount Cave's test is created by the removal of a disadvantage. In the former case the removal of a potential competitor constituted such an enduring benefit whereas in the latter case the taxpayer merely asserted an existing right, i.e. the right to use an invention on the expiry of a patent, in the face of threatened encroachment and competition was neither eliminated nor reduced. An alternative analysis might be that the patentee had a right to apply for an extension of the patent and the taxpayer in opposing that application was seeking to remove the disadvantage which would have resulted to it in the event of the application being successful. That disadvantage would have consisted not only in the taxpayer being denied the use of the invention but also a continuation of the adverse effect on its business resulting from a monopoly of the invention being vested in a competitor. To this extent it might be said that competition was reduced in the sense that the taxpayer was enabled to compete on more favourable terms than in the past.

[67] (1938) 2 K.B. 482, 498. *Cf.* Dixon, J. in *Hallstroms' Pty. Ltd.* v. *Commissioner of Taxation* (1946) 72 C.L.R. 634, at 646 who refused to concede that the distinction "is so indefinite and uncertain as to remove the matter from the operation of reason and place it exclusively within that of chance or . . . so unascertainable that it must be placed in the category of an unformulated question of fact."