IP3533 Implications of the *Mitsubishi* Decision

RULINGS UNIT ISSUES PAPER NO 2 — Project No 3533 (IP3533)

Date of issue: 10 December 1996.

Deductions — Restatement of "incurred" test — Deductions for estimated future expenditure not quantified or paid until later income years — Need to identify event giving rise to liability occurring within relevant income year and give reasonable estimate of expenditure — Application of s EF 1 — Expenditure added back as assessable income — Relevance of s DJ 1(c) — Warranties offered but reimbursements claimed — Income Tax Act 1994, ss BB 4, BB 7, DJ 1(c), EF 1.

Inland Revenue intends to draft and issue a public binding ruling or interpretation statement on the meaning and application of the "incurred" test following the Privy Council decision *Commissioner of Inland Revenue* v *Mitsubishi Motors New Zealand Limited* (1995) 17 NZTC 12,351.

To facilitate our consideration of the complex and important issues involved, we are inviting submissions from interested parties. Written comments are sought on the issues and questions raised in this paper and on any other issues relevant to the topic by 28 February 1997.

In particular, Inland Revenue invites your views on:

- The potential scope of the decision;
- The suggestion that adjustments for estimates be dealt with in an analogous fashion to the treatment of estimated future liability in the general insurance industry;
- The relevance of section DJ 1(c) (particularly in the context of warranty expenditure); and
- Section EF 1.

Following receipt and consideration of those comments it is proposed that a draft public binding ruling or interpretation statement will be circulated for comment.

All references are to the *Income Tax Act* 1994, unless otherwise indicated. Any public binding ruling or interpretation statement arising from this issues paper will take into account the *Taxation (Core Provisions) Act* 1996.

PART A Introduction

Purpose of this paper

1.1 This paper considers the Privy Council decision *Commissioner of Inland Revenue* v *Mitsubishi Motors New Zealand Limited* (1995) 17 NZTC 12,351 ("*Mitsubish*") and its technical implications.

1.2 Its purpose is to identify key issues and to act as a starting point for assessing the scope and content of a future public binding ruling or interpretation statement on the decision's impact. The aim is to initiate discussion and consultation on the issues raised. It is not anticipated that the initial public ruling or

interpretation statement will necessarily cover all the issues raised in this paper. However, these and other issues may form the basis of future public binding rulings and/or interpretation statements.

1.3 Any views expressed in this paper are intended to focus attention and stimulate discussion on the particular issues. They should not be treated as Inland Revenue's final, or even tentative, views. Observations and analysis provided to us will be taken into account in formulating those views in the course of preparing any future draft public binding rulings or interpretation statements.

Background to decision

1.4 Section BB 4 includes within a taxpayer's assessable income all profits or gains derived from any business.

1.5 Section BB 7 permits taxpayers to make deductions for expenditure or loss *incurred* in producing assessable income. It states:

> In calculating the assessable income of any taxpayer, any expenditure or loss to the extent to which it —
>
> (a) Is incurred in gaining or producing the assessable income for any income year; or
> (b) Is necessarily incurred in carrying on a business for the purpose of gaining or producing the assessable income for any income year—
>
> may, except as otherwise provided in this Act, be deducted from the total income derived by the taxpayer in the income year in which the expenditure or loss is incurred.

1.6 Mitsubishi Motors New Zealand Limited ("MMNZ") assembled new motor vehicles and sold them through franchised dealers. The dealers in turn sold those motor vehicles under warranty to retail customers. The warranty provided against defects appearing in the material or workmanship of the vehicle during the warranty period. Under the terms of the dealer franchise, MMNZ reimbursed dealers for expenditure incurred by dealers in meeting warranty claims. The issue before the courts was whether, in computing its profits or gains, MMNZ could deduct its anticipated liabilities under warranties which remained unexpired at the end of the income year, for vehicles sold during that income year.

1.7 The High Court found in favour of MMNZ.[1] Doogue J held that MMNZ was definitively committed to the warranty expenditure as at the time of sale and delivery of the vehicles.

1.8 The Court of Appeal also found for MMNZ, but on a different basis.[2] The Court considered that MMNZ was not definitively committed to warranty expenditure because the liability was contingent on a defect manifesting itself within the warranty period. However, the Court reached a similar result by concluding that part of the sale price represented unearned income; income that was not derived until performance of the warranty was completed or discharged.

1.9 The Commissioner appealed from that decision to the Privy Council. The case was heard in July 1995. Judgment was delivered on 3 October 1995. The Privy Council dismissed the Commissioner's appeal, finding for MMNZ on the question of deductibility on the basis that MMNZ was definitively committed to the future warranty expenditure.

Section EF 1

1.10 Following the Privy Council decision there has been conjecture about the possible application of section EF 1 (section 104A of the *Income Tax Act* 1976) to the facts of the case. Section EF 1 was not raised or discussed in *Mitsubishi*.

1.11 Section EF 1 deals with "accrual expenditure" that has been "incurred". It adds back at year-end as assessable income the unexpired portion of any accrual expenditure.

1.12 As a matter of logic the potential application of section EF 1 is a matter to be considered *after* the question of whether certain expenditure has been "incurred". It is a distinct issue. As such, it is considered separately in Part C of this paper.

PART B The "Incurred" Test

1. Analysis of the Privy Council decision

1.1 The first step in determining the implications of the decision is a close reading of the judgment. The manner and order in which the Privy Council approached the central issue, i.e. the meaning of "incurred", gives guidance as to the potential scope of the decision. The following consideration of the decision is broken down into parts, the order of which approximately follows the order in which these issues are addressed in the decision.

Profits or gains

1.2 The Privy Council started its analysis with reference to section BB 4(a)[3], i.e. all profits or gains derived from any business are deemed to be assessable income. The term "profits or gains" is not defined. The Privy Council concluded therefore that, *prima facie*, it bears its ordinary meaning as would be understood by someone in business or an accountant.

1.3 The Privy Council was satisfied that the evidence showed that it was in accordance with proper accounting treatment for MMNZ to match the reasonable estimation of the cost of meeting warranty claims against the corresponding income earned from vehicle sales in the relevant income year.

1.4 The Privy Council noted that the evidence before the High Court satisfied Doogue J that a reasonable estimation could be placed upon the anticipated liabilities:[4]

> Although it cannot of course be predicted whether any particular vehicle will turn out to be defective or how serious the defect will be, MMNZ can make a reasonably accurate forecast, based on previous experience, of what will be the total cost of remedial work for all vehicles sold in a given year. Normal commercial practice therefore requires that this amount should be brought into account as a deduction from income in estimating the profits or gains of the business in the year in which the vehicles were sold. (at page 12,352)

1.5 The Privy Council focussed on:

- the business/commercial context of the facts of the case;
- what is "normal" accounting and commercial practice;
- the fact that a *global* perspective as to liabilities is taken when adopting normal accounting/ commercial practice.

Structure of the Act

1.6 Section BB 4(a) must be read subject to sections BB 6 and BB 7. The Privy Council noted that these sections have been construed to mean that in the calculation of the profits or gains of a business, income is computed according to normal accounting principles, but that "expenditure or loss" may only be deducted under section BB 7. The Privy Council noted that section BB 7 makes it difficult to apply accounting practice which is not in accordance with its express terms.

1.7 The Privy Council also noted that, although there are parallels between the Australian and New Zealand legislation, there is a "striking difference", i.e. the fact that only the New Zealand legislation refers to "profits or gains". Accordingly, under New Zealand law it is arguable that normal accounting principles should be adopted so far as deductions are concerned, notwithstanding section BB 7.

1.8 MMNZ submitted that the Privy Council should remove this inconsistency by construing "expenditure or loss ... incurred" in section BB 7 to include all items of expenditure or loss which would be deductible on normal accounting principles. Although attracted to the argument, the Privy Council declined to adopt so "revisionist" an approach. It felt able to decide the case on the basis of existing authority.

1.9 In this regard it should be noted that as from 1 April 1997 the *Taxation (Core Provisions) Act* 1996 will apply and replace the current sections BB 6 and BB 7 in respect of the 1997/98 and following income years. The new section BD 2(1) provides an exhaustive definition of an "allowable deduction". Section BC 5 provides that a taxpayer's annual allowable deductions are the total of the allowable deductions under section BD 2 that are allocated to an income year under section BD 4. Section BC 6 determines a taxpayer's net income — essentially a taxpayer's annual gross income less a taxpayer's annual allowable deductions. Arguably, with the Act no longer referring to "profits or gains", and the deductions inherent in that term being made more explicit, any doubt that may have formerly existed as to the relevance of accounting principles to determine the deductibility of expenditure or loss has been removed.

The "incurred" test

1.10 The Privy Council considered that the New Zealand courts have "followed Australian authorities" on the meaning of "incurred". This is because the term is used in a similar context in the Australian legislation equivalent to section BB 7.[5]

1.11 "Incurred" has been held to mean that the taxpayer must have either paid or become "definitively committed" to the expenditure before a deduction will be available. As a summary of the test in the Australian and New Zealand context, the Court set out the four propositions put forward by Henry J in *AM Bisley & Co Ltd* v *CIR* (1985) 7 NZTC 5,082 at 5,096, i.e.:

- a particular expenditure is incurred for tax purposes in any income year if it constitutes **an existing obligation** which arose in the course of that year;
- where the expenditure arises under a written deed or agreement, determining whether or not it is an existing obligation is a question of **construction of that deed or agreement**;
- the fact that the expenditure **is not payable until some future date** does not of itself destroy its nature as an existing obligation;
- the fact that the expenditure **is a defeasible liability** does not of itself destroy its nature as an existing obligation.

1.12 The Privy Council made two specific observations about the test. First, that the test focuses on *particular* items of expenditure. The Court noted that this is a different approach from that usually adopted for accounting purposes. To be deductible, *each* item must satisfy the test of being an "existing obligation". There is no basis for taking an aggregate approach as is acceptable for accounting purposes.

1.13 Secondly, that the test involves characterising the nature of the legal relationship between the taxpayer and the person to whom the obligation is owed. It is noted that "on one view" this requires, as a matter of construction, deciding whether the obligation is *contingent*, or *vested, but defeasible*. The Privy Council described this as being a "nice distinction" and noted that it is one which can easily become a matter of language rather than substance and lead to conflicting results.[6]

1.14 The Privy Council considered that these two specific features of the "incurred" test demonstrate that the test is a *jurisprudential* rather than a *commercial* test. The Privy Council noted that this is an "unusual approach to a taxing statute", and one which can lead to tensions if formal legal doctrine is wholly divorced from commercial reality. This was illustrated by the Australian decisions in this area.

1.15 Therefore, in looking at the existing law on the "incurred" test, the Privy Council focused on the fact that:

- certain features of the test involve an approach, and therefore a potential outcome, which is different from accounting/commercial treatment;
- the application of the test can lead to "nice distinctions" that make it difficult to predict the correct outcome.

Applying the "incurred" test to the facts:

Analysing the warranty

1.16 The Privy Council considered that the "incurred" test is *primarily* one of construction.[7] It was therefore necessary to consider the words of the warranty.[8]

1.17 The key clause of the warranty provided:

> The vendor of the new vehicle described herein warrants to the original purchaser and subsequent owners that if in normal use and service during the relevant warranty period as provided below any defect appears in the material or workmanship of any part of the vehicle not otherwise warranted, and as soon as reasonably possible within 21 days of becoming aware of the defect, the purchaser returns the vehicle to the vendor's premises and notifies the vendor of the defect, the vendor will at the vendor's cost either (a) supply and fit, or (b) repair any such part acknowledged by the vendor to be defective.

The stipulated warranty period was the earlier of the expiration of 12 calendar months after delivery of the vehicle to the original purchaser, or until the vehicle had run 20,000 km.

1.18 The Privy Council identified the different approaches in the courts below to the analysis of the effect of the warranty, namely that:

- the warranty is a promise that *all* vehicles are free from defects at the time of sale, and therefore, in the case of any defective vehicle, the liability arises at the time of sale (the High Court approach); and
- *any liability* was contingent upon a defect appearing and being notified within the warranty period; until then no liability is incurred (the Court of Appeal approach).

1.19 The Privy Council said that it agreed with the Court of Appeal's approach. However, it then went on to say that in its view the form of the warranty is not the final consideration.[9] It was also necessary to look to two other principles, i.e.:

- the fact that the jurisprudential approach to the "incurred" test does not rule out statistical estimation of facts which have happened, but are not known to the taxpayer. (The Privy Council saw this as being distinct from treating an aggregate of contingent liabilities as a statistical certainty, which the Court acknowledged is not permitted under the jurisprudential approach.); and
- whether, in the light of all the surrounding circumstances, a legal obligation to make a payment in the future can be said to have accrued.

Statistical estimation of facts/events which have happened

1.20 The Privy Council looked to a body of case law dealing with the insurance industry. In particular, the Australian decision in *RACV Insurance Pty Ltd v Commissioner of Taxation* [1975] VR 1; 4 ATR 610.[10] In that case an insurance company was allowed to make a deduction from its premiums of an estimated sum to represent its "incurred but not reported" (IBNR) liabilities.[11] In law the liabilities were not contingent

because they had occurred within the relevant year of account. This was the case even though the insurance company did not know about them.[12]

1.21 The Privy Council noted (at page 12,355):

> In the later case of *Coles Myer Finance Ltd v Federal Commissioner of Taxation* (1992–1993) 176 CLR 640, 679, McHugh J remarked that the insurance cases involved a strained application of the earlier Australian decisions. This is true only in the sense that from a practical point of view, the distinction which they draw is irrelevant. But jurisprudentially the difference is clear enough.

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1.22 Applying the approach taken in the insurance cases to the facts of the case,[14] the Privy Council then concluded (again, at page 12,355):

> The relevance of this principle is that estimation on the basis of statistical experience can be used to conclude that 63% or thereabouts of the vehicles sold by MMNZ in fact had defects which would manifest themselves within the warranty period of twelve months or 20,000 km. The finding of Doogue J on the evidence was that '63% or thereabouts of all vehicles sold by [MMNZ] contain defects'. Since this information could only be derived from MMNZ's experience of warranty claims, their Lordships understand the finding to mean that this was the level of defects notified to dealers in accordance with the terms of the warranty.

1.23 Counsel for the Commissioner sought to refute this conclusion by arguing that the 63% of reported defects might include some defects which were not present at the time of sale, but manifested themselves within the warranty period. If this was correct then using past warranty claims information to estimate the liability for defects which had happened at year-end would not be reliable, because the estimate would include both types of defect. The Privy Council rejected this argument. Counsel was unable to think of any examples of defects which were not present at the time of sale. The Privy Council doubted that a defect in the material or workmanship of the vehicle would appear within 12 months of sale, unless it was present, even if hidden, when the vehicle left the assembly plant. It was therefore legitimate to have regard to the evidence that established that 63% of the vehicles would in fact have had defects.

Legal obligation to make payment

1.24 The Privy Council then returned to consider the "classical" incurred test, i.e. a contingent liability, compared with a vested, but defeasible liability. The Privy Council referred to the language usually used in applying this test i.e.:

- a contingent liability is one which is merely "impending, threatened or expected";[15]
- a vested, but defeasible liability is one to which the taxpayer is definitively committed, notwithstanding the possibility of defeasance.

1.25 The Privy Council reconfirmed the Court of Appeal's analysis of the warranty, i.e. that it requires manifestation and notification to trigger liability. However, the Privy Council considered that the Australian cases dealing with the incurred test show that the resolution of this issue does not simply depend on whether "future events which may determine liability are expressed in the language of contingency or defeasance". This may give rise to merely "theoretical distinctions".

1.26 The Privy Council restated this aspect of the test in the following terms:

> *whether, in the light of all the surrounding circumstances, a legal obligation to make a payment in the future can be said to have accrued.*

1.27 The Privy Council referred to Deane J in *Coles Myer* (supra) giving examples of linguistic contingencies, i.e. contingencies that were so unlikely as not to affect the certainty of the obligation.[16] The Court also referred to the facts in *Commercial Union Assurance Co of Australia Ltd*[17] where the Court disregarded a condition in an insurance policy requiring notice of occurrence of an insured event to be given within the stipulated time, on the grounds that according to the evidence the condition was hardly ever enforced.

1.28 The Privy Council considered whether there is a contingent, or merely a theoretical, liability in the case of warranty claims for MMNZ vehicles, given that the warranty required notification. The Privy Council concluded that there would be a contingent liability if one looked at *all* the vehicles in question, but *not if one only concentrated on the 63% of vehicles which were estimated to have defects*. In the case of those vehicles the Privy Council concluded that the existence of such defects "was a matter of existing fact, not future contingency"; it being only a theoretical contingency that the owners would be content not to make a claim. The Privy Council considered (at page 12,356) that owners of defective vehicles would not make a claim only in the most trivial of cases[18] and that this contingency:

> ... would not make any material difference to the accuracy of the estimated amount of expenditure to which the taxpayer could be said, as a matter of law, to be definitively committed.

1.29 On the basis of this analysis the Court held that the estimated warranty costs were deductible under section BB 7 at the time of sale.

1.30 The following conclusions can possibly be drawn from the Court's analysis/application of the "incurred" test:

- Where the expenditure arises under a written agreement then it is fundamental to analyse the nature of the obligation as set out in that agreement. However, this is only a first step.
- Where the event which gives rise to the liability has already happened as at year-end, but is just not known to the taxpayer, then it is permissible to adopt a reasonable estimate to determine the extent of that liability. That reasonable estimate may be based on past expenditure for a number of liabilities of a similar kind.
- In determining whether a liability is contingent or vested, but defeasible, theoretical contingencies are to be ignored. The question must be viewed in the light of all the surrounding circumstances and not just on the terms of the written agreement which gave rise to the liability (which might appear to include a contingency, but which in practice is not in any practical sense likely to impede liability).
- In circumstances such as those in the case, the failure to notify once manifestation had occurred was simply a theoretical contingency, unlikely to happen in practice.

Income recognition

1.31 The Privy Council gave no "concluded view" on the Court of Appeal's decision that the "warranty income" was earned over the period of the warranty. The Privy Council thought it unnecessary to do so because it had decided the warranty costs were deductible. However, it is noteworthy that the Court expressed "difficulty" with the Court of Appeal's "method of reaching what is undoubtably a sensible answer". The Privy Council considered that, unlike the question of deductions, the question of what income can be treated as "derived" during an accounting year is a matter governed by normal accounting principles. However, the Privy Council sounded a word of caution against "compensating" for difficulties which arise as to determining the deductibility of certain expenditure by manipulating the rules for the recognition of income.

1.32 Neither the facts (MMNZ had not charged a separate amount for the warranty), nor the accounting treatment (MMNZ had brought the whole price of the vehicle into account as income) supported the approach taken by the Court of Appeal. MMNZ's accounting treatment supported bringing the full sale price to account in the year of sale.[19]

1.33 The Privy Council chose to make no comment on the arguments in favour of spreading income advanced for the taxpayer under the accruals rules.

1.34 The wide approach to the recognition of income taken by the Court of Appeal was rejected by the Privy Council. Although the Privy Council did not formally overrule the Court of Appeal judgment (it did not have to because it decided the case on different grounds), the Privy Council clearly did not agree with the reasoning underlying that decision.

1.35 Although not considering income derivation directly, the Privy Council decision implies that, in applying the rules governing the recognition of income, a court:

- must consider what actually happened and not any retrospectively imposed economic analysis of what happened;
- may choose to consider the accounting treatment adopted at the time, as being relevant contemporaneous evidence;
- must consider separately, and apply different analysis to, the questions of whether expenditure is deductible and income derived.

Broader implications

1.36 *Mitsubishi* provides us with a new statement of the existing law on the meaning of "incurred". The existing law included cases in the insurance arena which permitted deductions for liabilities which had occurred, but were unknown and/or uncertain as to quantum at year-end. The Privy Council decision applies that line of cases to a new fact situation, i.e. warranty expenditure to remedy inherent defects.

1.37 In evaluating how *Mitsubishi* restates the "incurred" test, it is useful to "measure" the decision against the four propositions laid down in *Bisley* and referred to by the Privy Council:

- *a particular expenditure is incurred for tax purposes in any income year if it constitutes* ***an existing obligation*** *which arose in the course of that year;*

  Mitsubishi is seemingly authority for the proposition that whenever an event giving rise to a liability can be said to have occurred within the relevant period, and the number of such events and cost of meeting that aggregate liability can be reasonably estimated, then that cost is deductible.

  The requirement that there be a reasonable estimation can be on the basis of an aggregate, rather than a single, assessment of liability. The Privy Council reached this position notwithstanding that it acknowledged (at page 12,353) that to date the word "incurred" in section BB 7 had been interpreted as referring to particular items of expenditure "rather than the aggregate sums which would concern a businessman drawing up his accounts". The insurance cases give support to this aggregated approach.
- *where the expenditure arises under a written deed or agreement, determining whether or not it is an existing obligation is a question of* ***construction of that deed or agreement;***

  It is still vital to look to the terms of the arrangement which give rise to the liability so as to establish what is the event that gives rise to liability, and at what point in time an existing obligation to fulfil that liability arises. However, that is not the end of the matter. First, it is necessary to consider whether this is a situation where the liability has arisen, but is just not known, and can be reasonably estimated. And, secondly, whether there are any aspects, given all the surrounding circumstances, which make the liability to pay something less than an existing legal obligation.
- *the fact that the expenditure* ***is not payable until some future date*** *does not of itself destroy its nature as an existing obligation;*

This proposition was not discussed directly. MMNZ had not incurred any specific liabilities, as at year-end, to make payments in respect of unexpired warranties. Implicitly the decision acknowledges that expenditure may be incurred even if the obligation to pay, i.e. a pecuniary liability, necessarily does not arise until some future date.[20]

• *the fact that the expenditure* ***is a defeasible liability*** *does not of itself destroy its nature as an existing obligation.*

The Privy Council criticised the language used to date to express this aspect of the test.[21] On one interpretation, the decision has replaced the "contingent versus vested, but defeasible" dichotomy with a new test as to "defeasibility". On this basis, the new test might be: *whether, in the light of all the surrounding circumstances, a legal obligation to make a payment in the future can be said to have accrued*. In applying this test it is necessary to disregard merely theoretical contingencies. It is also possible to look beyond any legally binding arrangements which are pertinent to the creation of the liability, e.g. notice requirements.

1.38 Beyond restating the "incurred" test, *Mitsubishi* is also important for two other reasons. First, its discussion of accounting treatment. Secondly, its references to "normal commercial practice".

Accounting treatment

1.39 The Privy Council said that it was not prepared to interpret section BB 7 as including all items of expenditure which would be deductible on normal accounting principles. It also highlighted the fact that accounting treatment and the "incurred" test, as interpreted by the courts, were different. Nevertheless, the Privy Council reached a conclusion which accorded with the taxpayer's accounting treatment. This is an accounting treatment which is endorsed as being "the proper treatment of the outstanding warranty liabilities".[22]

1.40 The Privy Council was clearly cognisant of the accounting treatment adopted by MMNZ. However, the Privy Council applied the existing legal principles to the facts before it. In this case, the accounting treatment proved to be consistent with the law. This will clearly not always be the case. The aims of accounting and taxation are not the same. Generally, for taxation purposes a higher degree of certainty for the recognition of expenditure is required.

1.41 The significance that accounting treatment played in this case serves to confirm that the courts will consider accounting evidence. However, in the context of cases dealing with the issue of what has been "incurred", the taxpayer must still satisfy the legal requirements of that test. To fit within *Mitsubishi*, liabilities must be ones which have occurred within the relevant period (even if not known to the taxpayer), and in respect of which there is a legal obligation to make payment. It must also be possible to make a reasonable estimation of those liabilities.

1.42 *Mitsubishi* cannot be read as providing support for taxing on the basis of accepted accounting treatment. It will always be necessary to apply the relevant existing legal principles.[23] This is a reflection of the fact that the objectives of accounting and tax differ. In particular, accounting seeks to present a fair statement of the financial position of a taxpayer at a particular point in time (which may reflect only one result within a range of possible treatments), whereas tax is concerned with the precise measurement of income. However, accounting treatment continues to provide a useful yardstick against which to compare different legal analyses.

Common commercial practice

1.43 Throughout the judgment are indications that in reaching its decision the Privy Council had regard to what happens in the commercial world. The Privy Council considered that the section BB 4(a) reference to "all profits or gains derived from any business" must *prima facie* bear its ordinary meaning as understood

by those in business or accountants. In support of this approach the judgment includes (at page 12,352) the following extract from *Commissioner of Taxes (South Australia) v Executor Trustee and Agency Co. South of Australia Ltd* (1938) 63 CLR 108, 152:

> Income profits and gains are conceptions of the world of affairs and particularly of business... In nearly every department of enterprise and employment the course of affairs and the practice of business have developed methods of estimating or computing in terms of money the result over an interval of time produced by the operations of business, by the work of the individual, or by the use of capital. The practice of these methods of computation and the general recognition of the principles upon which they proceed are responsible in a great measure for the conceptions of income, profit and gain and therefore, may be said to enter into the determination or definition of the subject which the legislature has undertaken to tax.

1.44 The Privy Council also noted that the Australian courts have referred to the traditional "incurred" test as giving rise to a jurisprudential, rather than a commercial, view of the meaning of that term. As previously highlighted, the Privy Council detected from the Australian decisions a degree of tension between the two approaches; in its opinion, being expressed in a reluctance to accept a computation of taxable profits which is "wholly divorced from commercial reality".

1.45 The Privy Council's acceptance of an aggregate approach to the estimation of liability (for a number of similar events that have occurred, but are unknown) and its application of the defeasibility aspect of the test (i.e. disregarding theoretical contingencies) also shows a degree of willingness to have at least some regard to what would be a commercially realistic approach to the application of the law.

1.46 However, any such references to the significance of commercial practice must be read in the light of the underlying legal principles on which the case was decided. In referring to commercial practice, *Mitsubishi* provides another example (of which there are many) of the courts "testing" the result reached under the law against common commercial practice.[24] The case does not stand for the principle that taxation law is necessarily consistent with commercial practice.

2. Application of the "incurred" test after *Mitsubishi*

Warranties

2.1 *Mitsubishi* provides authority for the claiming of reasonable estimates for future warranty costs where motor vehicles are sold under a warranty against inherent defects. Generally speaking, the decision will apply to other motor vehicle industry manufacturers and assemblers who provide warranties of the same, or similar, type to that which featured in the case.

2.2 The decision will generally also apply to other manufacturing, distributing, wholesaling, and retailing taxpayers who provide warranties to remedy inherent defects in new[25] goods sold, e.g. computer manufacturers and distributors. However, in every case it will be necessary to show that anticipated future warranty expenditure relates to *defects present at the time of sale*. If a warranty provides cover on a different basis, for example "to keep goods in good working order", it may be that the liability under the warranty does not arise at the time of sale. The liability may relate to contingent events that occur after the time of sale, e.g. the manner in which the goods are used by the customer.[26]

2.3 In every case, in accordance with the Privy Council decision, it will also be necessary to satisfy Inland Revenue that a reasonable estimate of future costs supports the deduction sought. The decision will arguably only apply to taxpayers who are able to provide sophisticated, reliable information, being those taxpayers who have maintained records for a statistically relevant period, in the light of the taxpayer's particular circumstances. The amount deducted for tax purposes may vary from the reserve adopted for financial accounting purposes.

2.4 At this time it is difficult to provide anything beyond general guidelines as to what will, and will not, be acceptable evidence to support an estimation of future warranty expenditure. In time it may be possible to formulate guidelines for different industry groups. Submissions on the need for, and the potential content of, suitable guidelines from different industry groups are particularly welcomed.[27]

Free servicing

2.5 Many taxpayers who offer warranties to customers for new goods sold also offer free servicing for a defined period, or at a set time or times, from the date of sale, e.g. a motor vehicle warranty may include one free service after 10,000 kilometres. A free service may be offered on a general basis, or may involve a defined set of services, e.g. oil check, wheel alignment, etc.

2.6 In general terms, on the basis of *Mitsubishi*, taxpayers offering free servicing of this nature will be able to take a deduction for future free servicing costs in the year of sale. This is because the obligation to provide the free service arises at the time of sale. Considering all the surrounding circumstances, a legal obligation to make a payment in the future has arisen at the time of sale. In most cases it will not be reasonable to argue that the customer may not take up the offer, or not fulfil the terms of the offer, e.g. not drive the requisite distance. In most cases, particularly where the period in which the free service must be taken up is of a relatively short duration, it is only a theoretical contingency that customers will not take advantage of the free service. This is analogous to the Privy Council's finding that it was only a theoretical contingency, limited to customers with trivial defects, that customers with defective vehicles would not seek remedial work under the warranty.

2.7 However, a deduction at the time of sale will only be available where the taxpayer is able to substantiate the amount sought with reference to past servicing data, including the average cost of providing such a service (e.g. labour and costs). (In *Mitsubishi* the permitted deduction was based on a reasonable estimate calculated with reference to *actual* past claims.)

2.8 The offer of a free service on fixed terms (i.e. to provide a pre-determined number of services or replacement parts) is to be distinguished from a service contract. A service contract is generally an agreement whereby the vendor agrees to provide services *as required* by the customer over a period of time, e.g. 12 months from the date of sale. A service contract will generally not relate only to a pre-determined number of services, but will cover all repairs necessary during the contract period. Accordingly, at the time of sale it is uncertain whether the vendor will incur expenses under the service contract. This will depend in part on the manner in which the goods are used by the customer, and events subsequent to the entering into of the service contract.

2.9 Sometimes the distinction between warranties, free servicing arrangements, and service contracts may be blurred. A consideration of the terms of particular arrangements will always be necessary to determine whether a deduction for anticipated expenditure is available at the time of sale. In some cases it may be appropriate to apportion between anticipated expenses relating to inherent defects and free servicing arrangements, and other types of expenditure.

2.10 Servicing contracts may "stand-alone" from the sale and purchase of the underlying goods. In such cases the customer buying goods chooses whether to take advantage of the servicing contract and pays a separate consideration for entering into the contract. In some cases the taxpayer offering a stand-alone servicing contract may be able to spread the consideration received for such contracts.[28]

Implied warranties

2.11 It seems reasonable to conclude that *Mitsubishi* also applies to taxpayers who provide products subject to statutorily implied guarantees as to fitness, in so far as those guarantees relate to remedies for inherent defects present at the time of sale, e.g. those imposed under the *Sale of Goods Act* 1908, the *Consumer Guarantees Act* 1993, and the *Motor Vehicle Dealers Act* 1975. Provided taxpayers are able to

give reasonable estimates of the level of claims made for particular products under the applicable legislation, and the claims relate to defects which were in existence at the time of sale, then *Mitsubishi* will generally apply.

2.12 The *Sale of Goods Act* 1908 implies a condition into contracts for the sale of goods that the goods are of "merchantable quality".[29] Where goods are sold containing defects which render them unmerchantable, buyers have rights to recover damages. In many cases notification of a defect by the buyer to the seller will result in the seller remedying the problem at the seller's expense. Subject to certain common law and statutory restraints, sellers may contract out of the conditions implied under the Act. The *Sale of Goods Act* does not apply to the sale of consumer goods which are now covered by the *Consumer Guarantees Act* 1993.

2.13 The *Consumer Guarantees Act* 1993 applies to all transactions in trade for the supply of goods and services of a kind ordinarily acquired for personal, domestic, or household use. It imposes a set of statutory guarantees that are implied into all contracts for the supply of consumer goods and services. The Act applies to manufacturers, importers, retailers, and service providers. It imposes a guarantee that all goods supplied are of "acceptable quality".[30] It also imposes certain obligations on manufacturers to provide repair facilities and spare parts. With some limited exceptions, suppliers cannot contract out of the guarantees imposed under the 1993 Act.

2.14 The *Motor Vehicle Dealers Act* 1975 regulates the sale of secondhand motor vehicles by motor vehicle dealers. The Act imposes certain conditions into the contract of sale. The dealer must "repair and make good" any defect which appears in a vehicle within a prescribed period or distance travelled. The period depends on the category of vehicle, which in turn depends on the age and mileage of the vehicle. This obligation expressly applies to defects[31] whether or not they existed at the time of sale. This may mean that certain warranty costs will fall outside of the reasoning in *Mitsubishi*. It may not be possible to make reasonable estimations of future warranty costs arising out of inherent, as opposed to other, defects.

2.15 Inland Revenue anticipates that not all taxpayers who meet claims made under statutorily implied conditions will necessarily have sufficient historical and detailed statistical information to support the taking of a deduction. However, it is acknowledged that, in time, taxpayers may introduce recording systems to permit them to rely on the decision in the future.

2.16 Some taxpayers who provide a wide range of products, and/or an ever-changing selection of products, may never be able to rely on the decision. This is because it will be impossible to establish that a certain consistent level of warranty claims is made in relation to any particular product line.[32] Inland Revenue considers that *Mitsubishi* only applies in cases where the estimated level of warranty costs can be attributed to particular items based on their individual past sales records.[33] In other cases it will generally not be possible to provide a reasonable estimate of future liability. In such cases it will not be sufficient to produce statistics based on total sales compared with claims made.

Service providers

2.17 It has also been suggested that the reasoning in *Mitsubishi* may extend to taxpayers who provide services, rather than products. This would permit service providers to take a deduction for estimated future claims for deficient services in the year the services are paid for, e.g. professional advisers such as lawyers and accountants might argue that a level of tortious or contractual liability under common law always exists in the giving of their advice.

2.18 However, the arguments for applying the reasoning in the case seem significantly weaker as regards the provision of services. *Mitsubishi* dealt with sales of goods of like kind, i.e. vehicles, under warranty. The warranty established liability for inherent defects in the materials and workmanship. In many instances the provision of services will not involve the provision of services of such a similar and repetitive nature. Furthermore, whether services are "deficient" in terms of meeting the requirements of the agreement they are

provided under, or obligations implied under statute or at common law, may not be certain. It may not be able to be said that the services were deficient at the time they were provided. This may be a contingency which depends in part on circumstances arising after the services were provided.

2.19 In addition, when compared with the facts in *Mitsubishi*, it would be unusual if a service provider could estimate with a reasonable degree of certainty that "x"% of its services were inherently defective. It is more likely that a service provider will have an erratic history of claims made against it which would make it difficult to argue that any particular sum is a reasonable, annual estimate of potential future claims for particular "defective" services. It is also more likely in the services arena for taxpayers to be held liable not only for expenditure in the nature of "repairs" (i.e. putting right the direct "defect") but also for any consequential loss. It seems reasonable to assume that in most cases it would not be possible to quantify liability for consequential loss on any reliable, annual basis. In the case of some service providers, the distinction may be between a conservative "provision", suitable for financial accounting purposes, and a quantifiable deduction for tax purposes.

2.20 A distinction may also be drawn between express or statutorily implied contractual liability under the terms of a warranty, and liability arising under a contract or at common law generally. The former is analogous to strict liability. The latter is less certain in scope in terms of the extent and likelihood of liability arising. It seems that the better view is that taxpayers cannot make deductions for threatened (including estimated future claims) for damages. A threatened claim for damages is not incurred until the taxpayer has paid, is found liable to pay, or has agreed to settle a particular claim.[34]

Section DJ 1(c)

2.21 Section DJ 1(c) provides that notwithstanding the ability to make a deduction under section BB 7, no deduction, except as expressly stated in the Act, shall be made for "any expenditure or loss recoverable under any insurance or right of indemnity".

2.22 Section DJ 1(c) has not been considered by the courts. Nor, it appears has the meaning of "indemnity", as it appears in any other provision of the Act or more generally, been considered by any New Zealand court. In simple terms a contract of indemnity is a contract by one party to keep another party harmless against loss.[35] In a strict sense it denotes an obligation to keep the promisee harmless against claims by third parties. *Prima facie*, this may apply to the contractual relationships relating to the sale of goods which exist between retailers, distributors, importers, assemblers and/or manufacturers of goods; such contractual relationships may arguably create rights of indemnity.

2.23 In the case of many distributors and retailers selling products subject to warranties, the distributor or retailer's liability to its customers will in turn be wholly or in part matched by a warranty or indemnity from the manufacturer and/or the distributor or wholesaler which supplied those products to them.[36]

2.24 In some situations it may be arguable that this kind of "back to back" warranty is in fact a form of indemnity. When this is the case, section DJ 1(c) may apply so that no deduction will be available. The distributor or retailer cannot take a deduction for estimated warranty costs when those costs are in turn met by a third party (further up the selling/distributing chain). As a consequence, where the party bearing the ultimate liability under the warranty is offshore, in practical terms the timing advantage in applying *Mitsubishi* would not apply to the New Zealand based taxpayers further down the selling/distribution chain.

2.25 A more difficult issue arises where there is no immediate right to indemnification. In some cases retailers, who honour warranties to their customers, will in turn have to satisfy the terms of their contracts with distributors or manufacturers. This may lead to situations where the taxpayer seeking indemnification does not receive full reimbursement — perhaps due to the terms of his or her contract not being identical to the terms of the underlying warranty; the taxpayer choosing to indemnify outside the strict terms of the warranty and/or liability arising due to some fault on the part of the taxpayer, rather than the distributor or manufacturer. This may raise doubt as to whether the arrangement is in fact an "indemnity", or form

of "insurance", in terms of section DJ 1(c). In such situations taxpayers may be able to show from past experience that a certain percentage of expenditure is not recoverable under a right of indemnity, and may argue therefore that section DJ 1(c) should not apply to that extent.

2.26 Further consideration will be needed to ascertain how section DJ 1(c) is being interpreted and applied at the present time. It is possible that deductions are being taken at the time expenditure is incurred, with subsequent indemnity payments being treated as assessable income when received.[37]

2.27 In some cases it may be necessary to differentiate between expenses incurred for which there is a right of indemnity and other expenses which are borne by the taxpayer, e.g. where a manufacturer provides indemnification to an assembler/distributor for defective parts. The assembler/distributor may only be able to make a deduction in accordance with *Mitsubishi* for future expenditure under a warranty to the extent that it is not indemnified for the defective parts aspect of any warranty claim. It may be that taxpayers in such circumstances, in making a reasonable estimation of their future warranty liabilities, will need to make a reasonable estimation (based on past data) of the quantum of indemnification which will be received.

Wider implications

2.28 It seems that the reasoning in *Mitsubishi* is potentially wider than the giving of warranties. However, in seeking to rely on the decision it will always be necessary to determine the "event" which triggers liability. Only where that event can be said to have occurred during the relevant income year will a deduction be available (subject to providing a reasonable estimate).

2.29 As seen in the *Mitsubishi* decision itself, it is not always an easy task to identify the event which creates liability. The Court of Appeal thought it was the manifestation of the defect; the Privy Council, in effect, disagreed and considered it to be the act of sale of a vehicle containing an inherent defect which would manifest itself within the warranty period. The difficulty with the "incurred" test has always been in anticipating how it will apply to new or unique fact situations. In restating that test, the Privy Council decision appears not to have made that task any easier.

2.30 In particular, the Privy Council decision raises difficulties in terms of applying it to other fact situations because:

- although the Privy Council recognised that section BB 7 is concerned with *particular* items of expenditure, rather than deductions for aggregate sums (at page 12,353), it goes on to reach its decision on the basis of an estimate of aggregate liability (at page 12,356).
- the decision purports to apply the same principles as were applied in the "insurance cases" (*RACV Insurance* and *Commercial Union*). However, in those cases a deduction was permitted in the current income year for liabilities which had occurred during that income year, but had not been reported to the taxpayer. Because of the nature of insurance, it was probable that the taxpayer would be made aware of its liability to particular insured parties within a reasonable period following that income year. In *Mitsubishi* a deduction was permitted for a liability occurring in the current income year (the sale of an inherently defective vehicle subject to a one year warranty). Again, in practical terms, MMNZ was likely to be aware of the actual number of claims arising out of those sales within a reasonable time following that income year due to the relatively short warranty period. However, had the warranty period been, say, ten years, this would not have been the case — although, arguably, applying *Mitsubishi* a deduction for a reasonable estimate of future liability during that period would still be available.
- the decision does not address the issue of how to determine the level of deduction where liability may be absolute, in terms of the contractual obligations of the taxpayer, but the likelihood of having to meet that expenditure is less than 100%. This issue did not arise in the case because the Privy Council chose to ignore the possibility of some owners not claiming remedial work for defective vehicles sold during the relevant income year. Their Lordships considered that this possibility could be ignored because it was only likely to happen in the most trivial of cases and therefore would not affect the accuracy of the estimated amount of expenditure. By ignoring this potential

reduction to the estimated liability, their Lordships were able to accept the estimate of liability for the current income year, based on past claims made. But this approach leaves it unclear as to how to deal with the possibility that the actual level of liability may be less than the contractual liability. In cases where there is a more than trivial difference between the level of contractual liability and the estimated actual level of liability, it might be arguable that there is no existing obligation — the liability is still a contingent one.

2.31 In addition, in applying the "incurred" test in the future, it should also be borne in mind that *Mitsubishi* dealt with a particular set of facts — essentially trying to ascertain whether an aggregate of liabilities (the cost of meeting warranty obligations for inherent defects present in vehicles sold during the relevant income year) had been incurred. The issue of whether certain expenditure has been incurred will not always arise in situations analogous to that in *Mitsubishi*. In particular, it is suggested that in cases of "one-off" expenditure case law prior to *Mitsubishi* will still be of relevance. In such cases it may well still be relevant to ask whether the particular expenditure is no more than "impending, threatened or expected".

2.32 At this stage it is anticipated that any public ruling or interpretation statement issued by Inland Revenue will emphasise the application of the case to factual situations closely analogous to it. Such a ruling or interpretation statement will most likely stress:

- the importance of identifying the event which triggers liability; otherwise the liability is merely a contingent one. It must be an event analogous to the presence of an inherent defect at the time of sale;
- that the decision does not permit deductions for general provisions and reserves;[38]
- the importance of providing reliable evidence and establishing credible methods on which to base a reasonable estimation of future liability and expenditure.

Conclusions

2.33 The case applies to express warranties of the type considered in *Mitsubishi*. It probably also applies to warranties and guarantees of a similar nature implied under statute.

2.34 The Privy Council decision has potentially widened the application of the "incurred" test. This will mean that certain taxpayers are able to claim deductions in anticipation of expenditure where previously a deduction could be claimed only after an obligation to pay an identifiable, individual sum had arisen. However, it will always be necessary to identify the event which gives rise to the liability, and to determine whether that event has occurred prior to year-end.

2.35 When taxpayers can rely on indemnities to cover estimated warranty (or other anticipated) costs, section DJ 1(c) may mean that no deduction can be taken.

3. Reasonable estimations

3.1 To rely on *Mitsubishi* taxpayers must be able to make a "reasonable estimation" of the quantum of the liability concerned.

3.2 The Privy Council noted (at page 12,352) that the High Court was satisfied on the evidence that a reasonable estimate could be placed on the anticipated liabilities:

> 63% of the vehicles sold by MMNZ in the year 1988 were returned to the dealers for some kind of work to be done under the warranty. Although it cannot of course be predicted whether any particular vehicle will turn out to be defective or how serious the defect will be, **MMNZ can make a reasonably accurate forecast, based on previous experience,** of what will be the total cost of remedial work for all vehicles sold in a given year. (*Emphasis added*)

3.3 However, there is no legal discussion by the Privy Council as to what constitutes a reasonable estimation, nor what methods may be adopted in reaching such an estimation.

3.4 Similarly the Court of Appeal decision was premised on the basis that (at page 11,100):

> [MMNZ's] accounting data enable it to provide what the Commissioner accepts are reasonable and reliable estimates as at the end of the tax year in which the vehicles are sold of the costs of meeting its obligations in respect of future claims.

3.5 The reality is that this issue was never argued before the High Court[39] and from then on was taken as an assumed fact, i.e. that MMNZ was able to reasonably estimate the warranty costs, and had in fact done so. At the conclusion of his judgment Doogue J in the High Court referred to the significance of this issue, but noted (at page 10,170) that in this case he was not required to address it because the issue had not been "seriously disputed" by the parties:

> The secondary question arises as to what allowance is to be made for the particular income year. Given the nature of the submissions before me, this question can be shortly answered. The question raised by Lord Radcliffe in the *Southern Railway* case:
>
> 'Do the circumstances including the techniques of established accounting practice make it possible to supply a figure reliable enough for the purpose?' [i.e. to establish the appropriate deduction]
>
> In this case it was not seriously disputed, although no concession was formally made, that MMNZ had adopted a formula which reasonably enabled the appropriate deduction to be ascertained and determined, notwithstanding that in any particular income year there may be room for argument between the taxpayer and the Commissioner as to whether the sum is an appropriate one.

MMNZ's calculations

3.6 As a starting point for determining what is a reasonable and reliable estimation it is perhaps useful and illustrative to briefly consider the evidence Mitsubishi presented. In referring to the evidence that MMNZ adduced, this paper *does not endorse* that evidence as being a reasonable estimation.[40] The scope and nature of the actual evidence relied on, and the underlying methods of calculation adopted by MMNZ, raise issues regarding the acceptable parameters of what is a reasonable and reliable estimate.

3.7 MMNZ's financial accounting manager and its warranty supervisor presented evidence for MMNZ of the method adopted in calculating the estimated warranty costs for the 1988 income year (as ascertainable from the proofs of evidence filed in the High Court).[41]

3.8 The proof of evidence of MMNZ's financial accounting manager sets out the formula used to estimate future warranty costs. (MMNZ used this formula until 1990.) The evidence stated that the object of the formula adopted was to estimate, as nearly as possible, the costs which would be paid, in future years, in meeting warranty claims on all vehicles sold in the year to which the accounts relate. Broadly, MMNZ's formula involved two steps:

- The first step was to estimate the cost per unit (type of vehicle) to be paid in future years. This was achieved by taking the actual amount of warranty costs paid in the year of account (the income year to 31/12/88), and dividing that by the number of vehicles to which those expenses related. For the income year to 31/12/88 MMNZ took the number of vehicles sold between 1/8/87 and 31/7/88. The witness said that this period was taken (rather than the income year) because MMNZ's records showed that most warranty claims were paid within the first six months of a vehicle's life.[42]

• The second step was to apply the estimated warranty cost price per vehicle to the relevant number of vehicles. To estimate this number MMNZ took the number of vehicles sold in the last five months of 1988.

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3.9 The evidence then went on to describe how the warranty cost per unit was calculated. MMNZ identified three types of costs, i.e. factory costs, non-factory costs,[44] and profits on parts. These were calculated for each category of vehicle assembled by MMNZ between 1/8/87 and 31/7/88. The factory costs were calculated with reference to actual expenditure. The non-factory costs were estimated, and "adjusted for future expected unit cost movements". The evidence noted that these costs were probably not based on actual figures because of a change in the basis of recovery of costs from MMNZ's parent company.[45]

3.10 A profit on the "cost" of parts was included. This was the total value of profit on parts for all claims paid between 1/1/88 and 31/12/88. It appears that MMNZ added into its total warranty costs estimation an amount representing the estimated loss of profit, due to the fact that some parts would be used to satisfy warranty claims rather than being sold at a margin/profit.

3.11 The three types of "cost" were then multiplied by the number of vehicles sold between 1/8/88 to 31/12/88 to reach a total estimated outstanding warranty costs' provision for the income year to 31/12/88.

3.12 The only aspect of this analysis which reached the courts was the reference to MMNZ having known at year-end that approximately 63% of the vehicles sold in the year to 31/12/88 had given rise to a warranty claim. MMNZ then used this percentage (in the way set out above) to estimate the level of outstanding warranty claims for vehicles sold during that period.

3.13 With the advantage of hindsight, it seems that MMNZ's provision was a considerable understatement of the warranty costs subsequently claimed in relation to vehicles sold in the year to 31/12/88. The evidence showed that MMNZ tended to understate (i.e. take a conservative approach to) its provision for unclaimed warranty costs.

3.14 MMNZ's evidence demonstrates that it was able to track the warranty history of every vehicle sold and warranty claim made. The evidence adduced by the warranty supervisor gave details of the development of the company's information systems. Post 1988, that system became fully computerised and integrated with MMNZ's sales and marketing data capture systems.

3.15 A close analysis of MMNZ's evidence shows that:

- MMNZ maintained detailed sales and cost figures;
- it took the calculation of warranty costs (provisions) "seriously", as demonstrated by its information systems and the appointment of a warranty supervisor;
- it had a long-standing approach to calculating provisions for warranty costs for accounting purposes;
- the formula used tended to give results which understated, rather than overstated, the actual costs involved.

3.16 Although none of the *Mitsubishi* judgments give any guidance as to what is a reasonable and reliable estimate, it is suggested that the standard demonstrated by MMNZ itself shows that it is clearly not sufficient that a taxpayer merely relies on unsupported figures — an "educated guess". It is noteworthy that the approach adopted by MMNZ resulted in an estimate for the relevant period that turned out to be a considerable under-estimation. Some commentators might suggest that the standard adopted by MMNZ was not necessarily sophisticated enough, and that this actual under-estimation could be cited in support of this conclusion. Notwithstanding this background to the decision, it is Inland Revenue's view that it is reasonable to require taxpayers to satisfy a rigorous standard as regards the provision of detailed information

and credible calculation methods to support provision calculations. This approach is acknowledged by a number of commentators.[46]

Judicial consideration

3.17 The issue of what constitutes a reasonable estimate of expenditure or loss under section BB 7 appears to have had very little consideration by the New Zealand courts.[47]

3.18 However, the Australian courts have recently considered the question. In ANZ *Banking Group Limited v Federal Commissioner of Taxation*,[48] the Full Federal Court, drawing in part on earlier decisions, had the following to say about what is a reasonable estimate in the context of a provision for insurance claims:

> • An "estimate" does not involve arbitrarily seizing upon any figure.
> • An estimate involves forming a judgment or opinion based on reason.
> • The opinion or judgment must be *bona fide* but need not be exact as estimation involves a process of approximation.
> • There is no rule as to the proper way of making an estimate. It is a question of fact and figures whether the way of making the estimate in any case is the best way for that situation (*Sun Insurance Office v Clark*).[49]
> • The concept of a "reasonable estimate" appears to mean "susceptible of more or less accurate estimation" or "capable of approximate calculation based on probabilities". The fact that an estimate is wrong does not mean it is unreasonable.

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3.19 In the *ANZ Banking* case the estimate of workers' compensation liabilities for a self-insurer in respect of injuries which had occurred prior to balance date was accepted as a reasonable estimation, even though there was a relatively short history to utilise in calculating the estimate. In particular, Hill J agreed that the estimation was *bona fide* and that the method of estimation (case by case analysis carried out by an appropriate expert) was acceptable and was an exercise capable of approximate calculation on probabilities.[51]

3.20 The *ANZ Banking* case supports a rigorous approach to the application of *Mitsubishi* to estimations provided by taxpayers. This may mean that larger and/or more sophisticated taxpayers are favoured over smaller taxpayers who for cost reasons do not maintain comprehensive computer systems and historical data.

3.21 Difficulties are likely to be encountered in setting general guidelines for what is required by individual taxpayers in terms of providing reasonable estimates. However, in broad terms, at a minimum, it is anticipated that taxpayers must be able to substantiate their estimations by reference to documentation evidencing past liabilities e.g. sales records, claims data, etc., and be able to justify any adjustments made from that information for future years. It will also be necessary to have *sufficient* data, in terms of providing a credible "history of past expenditure", in order to give a reliable estimation. It is anticipated that any public ruling or interpretation statement issued by Inland Revenue will stress the need for taxpayers to justify their methods of calculation in the light of their particular circumstances. It will also be necessary for taxpayers to continually reassess the method of estimation adopted.

3.22 It would generally not be appropriate for taxpayers to simply adopt a set percentage of sale or cost price from year to year without reference back to actual levels of warranty expenditure, for the same or similar products, for past years. Taxpayers will need to show that their deductions for each year reflect a reasonable estimate of future warranty expenditure calculated *for that particular income year*. Use of an inflexible percentage calculation may suggest that the taxpayer is simply making a conservative provision. This may be appropriate for accounting purposes, but will generally not be a reasonable estimate for tax purposes.

3.23 In other cases it may not be possible for a taxpayer to make a reasonable estimate due to:

- inadequate record keeping; and/or
- changes in product line or other relevant circumstances which make it difficult to use past years' information to reliably ascertain future liability.

3.24 It may also be discerned that, in cases where taxpayers are unable to make a reasonable estimation, and thereby take a deduction for estimated expenditure, a deduction will generally be available for that expenditure in the year that the liability becomes capable of reasonable estimation. Establishing that a liability is capable of reasonable estimation is considered to be part of the test of whether that liability has been "incurred". Accordingly, a deduction may be made in the earliest year that a reasonable estimation of the future expenditure can be determined. In some cases no deduction will be available until the year in which actual payment or liability for payment for an individual and identified amount occurs. This is because no reasonable estimation can be made before that time.[52]

3.25 In addition, a reasonable estimation for *future* expenditure may need to take into account anticipated rises and falls in the cost of meeting that expenditure at the time that it is reasonable to anticipate that the expenditure will be paid. However, any increases (or decrease) on current costs will also need to be substantiated on the basis of a reasonable estimation. In this regard it is also noted that the Act does not require any "discounting" of expenditure which has been "incurred" in a particular income year to take into account the fact that it will not be paid until some time in the future. The Act applies to nominal, rather than present value, sums.[53]

Insurance industry

3.26 On the basis of the *RACV Insurance* decision, general insurance companies have for a number of years been permitted to make a deduction for an "Incurred But Not Reported" (IBNR) reserve. In accordance with existing practice, Inland Revenue has to date accepted 2% of net premiums as a basis for this provision. Alternatively, taxpayers may seek approval to adopt a higher figure if this can be supported on the facts of a particular case. In practice, as a guideline, Inland Revenue requires a minimum five-year rolling average of actual figures to support a taxpayer's calculations.

3.27 General insurance companies have also been permitted to make a reasonable estimate for claims that have been incurred and reported, but not paid out at year-end. The estimate gives rise to a deduction for an outstanding claims reserve (OCR). The claims may not have been paid out because the insurer has not admitted liability and/or the loss has yet to be quantified. Such estimates are made on an individual claim basis.

3.28 To date no allowance has been permitted for "ancillary" expenses that are likely to arise in connection with the settlement of estimated claims included in the claims reserve (e.g. litigation expenses). This policy is presently under review in the light of the *Mitsubishi* decision and an industry submission has been received on this issue. However, Inland Revenue considers that there may well be a distinction between estimating the cost of meeting a future obligation, and extending that quantification to include costs which may be consequent upon meeting that claim, but for which the taxpayer is not contractually liable to incur. Further submissions on this issue are welcomed.

Conclusions

3.29 To rely on *Mitsubishi* it is paramount that taxpayers are able to make a reasonable estimation of the relevant future expenditure. To the extent that it is not possible to make a reasonable estimation, the expenditure will be treated as having not been incurred in that income year.

3.30 The standard of calculation demonstrated by MMNZ in the case, and past case law on what is a reasonable estimation, indicate that a rigorous standard as regards the provision of detailed information and calculation methods to support claims for deductions based on estimations is required. Inland Revenue will

be requiring taxpayers to substantiate claims made on the basis of estimated future expenditure in the light of their particular circumstances.

3.31 In the light of the issues surrounding what constitutes a reasonable estimation, Inland Revenue invites submissions from taxpayers and their advisers as to the level and nature of information that should be required, and that might be available and/or provided in order to satisfy this aspect of the "incurred" test.

4. Treatment of adjustments

4.1 *Mitsubishi* permits taxpayers to make deductions in the year of sale for *estimated* warranty costs which will in most instances prove to be incorrect in following years when compared with actual expenditure. The original deduction will either prove to be an over- or under-statement of the *actual* expenditure incurred. In the case of most warranties it will be several years after the expiration of the warranty before the total warranty costs for any particular year are known.[54]

4.2 The fact that an estimate will almost inevitably not reflect the "true" future liability has not been seen by the courts as being fatal to the taxpayer's ability to make a deduction based on an estimate — as seen the estimate does not have to be "right", just reasonable.[55] However, from Inland Revenue's perspective, it raises the issue of how to deal with the potential mismatch between estimated expenditure and actual expenditure. It also raises the issue of how to deal with revised estimates, e.g. can and should the accounts for the year in which the original estimate is deducted be reopened (and if so when and on what basis), or should ongoing adjustments be made in later years?

General insurance industry — IBNR claims

4.3 As seen, the Privy Council decision refers to the taxation treatment of the insurance industry; in particular, the judicial acceptance that reasonably estimated provisions for IBNR claims are deductible. Inland Revenue currently permits general insurance companies to take a deduction for IBNR reserves. A deduction is permitted for estimated IBNR claims as at the end of the relevant income year. However, the taxpayer must add back as income the value of claims settled during the income year for IBNR claims for previous income years. There is no statutory authority for this treatment. However, there is judicial support for this approach indirectly in the *RACV Insurance* case and more explicitly in the *Commercial Union* decision.

4.4 The treatment was summarised by Newton J in *Commercial Union* (Supreme Court of Victoria) (at page 445):

> In a case where a provision for claims outstanding at the end of a year is an allowable deduction in calculating the taxable income of an insurer for that year, then when those claims come to be paid in the future, they must for income tax purposes be debited against the amount of that provision, so far as it is sufficient for the purpose. The claims cannot be treated as allowable deductions from the assessable premiums earned by the insurer in the year in which the claims are paid for the purpose of calculating the insurer's taxable income of that later year, except insofar as the provision proves insufficient to meet them. **Otherwise claims would be treated as allowable deductions twice over.** (*Emphasis added*)

4.5 Newton J went on to describe how this treatment is achieved in the taxpayer's accounts:

> A convenient method of achieving the result just referred to, is to treat the amount of the provision for outstanding claims at the end of one year as part of the insurer's assessable income of the following year together with the earned premiums of that year, and then to calculate the insurer's taxable income for that second year by deducting all the claims in fact paid during that year, plus a provision for outstanding claims at the end of that year, plus, of course, administration and like expenses attributable to that year. **Many of the claims paid during the second year will of course have been**

> **claims which were outstanding at the end of the first year, and they will thus in fact be debited against that provision for outstanding claims at the end of the first year, because that provision is treated as part of the assessable income of the second year.** This method is perhaps technically incorrect, because the provision for outstanding claims at the end of the first year was part of the assessable income of that year, and cannot therefore also be part of the assessable income of the second year, except insofar as the provision may prove to have been excessive ... however this may be, the method nevertheless produces the correct result ... (*Emphasis added*)

4.6 Newton J noted that a shorthand method to achieve the same result is to compare the provision for claims outstanding at the end of one year with the provision for claims outstanding at the end of the following year, and to treat any increase as an allowable deduction for that second year, and any decrease as part of the assessable income of that year. This method is reflected in current Inland Revenue return forms for non-life insurance companies.[56]

4.7 Further support for this approach is found in the Privy Council decision *Southern Pacific Insurance Co (Fiji) Ltd v IRC (Fiji)*.[57] That case concerned the deductibility of IBNR reserves by a underwriter of general insurance, including third party motor insurance. The Privy Council confirmed that the amount of the liability of the taxpayer company for accidents which had occurred, but were not reported, in a particular year is part of the expense of the company in carrying on its insurance business during that year, and must be deducted in arriving at the total income of the company for that year.

4.8 Of relevance to the question of adjustments, the Privy Council noted:

> ... the Court of Appeal suspected that provision for an IBNR claim in one year would be duplicated by providing for an outstanding claim once the IBNR claim was reported. This suspicion is ill-founded. A claim, when reported, disappears from the next valuation of IBNR and becomes part of the next valuation of outstanding claims unless it has been settled in the meantime. IBNR and outstanding claims are adjusted each year by reference to the provision made at the beginning of the year. There is thus no double provision.

4.9 This treatment has also been endorsed by the Australian Taxation Office in a 1991 ruling on general insurance activities.[58] The ruling provides that a general insurer compares the amount of its outstanding claims provision at the end of an income year with the amount of the provision at the previous year-end. Any increase in the provision is allowed as a deduction, and any reduction in the provision is included as assessable income. The ruling refers to the *RACV Insurance* and *Commercial Union* cases in support of that stance.

4.10 Thus, adjustments for over- and under-estimations in the insurance industry are made on a "rolling" basis (in a similar fashion to the treatment of trading stock and the operation of section EF 1.) This has the practical advantage of not requiring previous years' assessments to be reopened. In the case of warranty costs this would inevitably involve reopening past years[59] at the end of each income year as it became apparent that the actual costs incurred were different from those estimated and/or that past estimations in themselves should be adjusted up or down. This may lead to an unworkable position from a compliance perspective.

Wider application

4.11 It is suggested that the approach taken in the insurance industry provides a workable treatment for dealing with adjustments in the context of estimated warranty costs. However, it is acknowledged that there are difficulties with justifying this approach within the statutory framework for the recognition of income and deductions. Dicta from the *Commercial Union* case highlight the fact that this treatment is not strictly in compliance with ordinary income concepts. The deduction for estimated IBNR claims is taken into account

in the year in which the liability has arisen. Strictly, in the absence of express legislation, it cannot then be added back in the following year as "income" against which is offset actual expenditure.[60]

4.12 Arguably, from a strict interpretation of the legislation, taxpayers who make a *reasonable* estimation for future warranty costs in one year that proves to be an over-statement of actual costs cannot be required to adjust for that over-statement in a later income year. The estimated liability has been *incurred* in that first year. Arguably, there is no legislative basis for adding back the over-statement (through a "rolling" adjustment treatment or otherwise).

4.13 Conversely, however, where a taxpayer makes a reasonable estimation for future warranty costs in one year that proves to be an under-statement of actual costs in a later year, the taxpayer may be able to take a further deduction for the additional actual expenditure in the year that the expenditure is paid. It may be argued that such additional expenditure was not *incurred* in the first year (because it did not form part of the estimated expenditure). However, it was incurred in the year in which it was actually paid (or the taxpayer became liable to pay an identified sum).[61]

4.14 Notwithstanding the difficulties in reconciling this treatment with the legislative framework of the Act, Inland Revenue considers that in the absence of express legislation dealing with estimated but incurred expenditure, this approach may produce the best and most workable solution to the question of adjustments. It has been used and accepted for a long time in the context of general insurance taxpayers and IBNR reserves. In that context it has received judicial support. It is therefore proposed to apply this approach to estimated warranty costs for which deductions are available in accordance with *Mitsubishi*. However, Inland Revenue welcomes submissions on this issue and the perceived applicability of this approach to estimated warranty costs and other types of estimated expenditure.

Features of treatment

First year of deduction

4.15 Even if it is accepted that the method used in the general insurance industry for dealing with IBNR claims provides the most logical approach to the treatment of estimated warranty costs, this still leaves open the question of how the first year of estimated deductions should be handled. Both the *RACV Insurance* and *Commercial Union* cases touch on this point. The concern here would be to ensure that in the first year that an estimated deduction is allowed, a "windfall" does not arise by virtue of a deduction being available for estimated claims without a corresponding adding back of the estimated claims as at the beginning of the relevant income year.

4.16 Dicta from these cases, and the ATO Rulings interpreting these decisions, make it clear that generally only the difference between these two amounts is deductible in the first year an estimated basis is adopted for tax purposes.[62]

4.17 It is suggested that similar treatment could apply to taxpayers seeking to make deductions for estimated warranty and other costs on the basis of *Mitsubishi*. In moving to an estimated basis, taxpayers would generally need to calculate the adjustment for the beginning and end of the relevant income year. Only the increase between the amount attributable to estimated future costs at the end of the income year and the amount of such claims at the beginning of the year will be deductible.

Re-estimation

4.18 Another feature of the treatment of insurance claims is the recognition by the courts that in some cases it may be appropriate to re-estimate previous years' estimates for claims, i.e. to make a further adjustment for anticipated claims relating to a previous period which at the end of the current accounting period are still outstanding. (It should be noted that re-estimating in some circumstances, given the level of the re-estimation and/or the nature of the events surrounding the re-estimation, may indicate that the original estimates were

not in themselves reasonable, and, in turn, raise issues as regards the methods of estimation being adopted by the taxpayer. As indicated previously, it is Inland Revenue's view that taxpayers must at all times satisfy a rigorous standard as regards their methods of calculating estimated liabilities.)

4.19 In the context of estimated warranty costs, a need for re-estimation might occur where the cost of replacement parts suddenly escalates, or it is shown that an unexpected repetitive defect in a particular warranted product has arisen. In such instances it may well be prudent from an accounting/commercial perspective to re-estimate the anticipated cost of meeting outstanding warranties.

4.20 The insurance cases indicate that re-estimations of this type should be taken as a deduction in the year in which the re-estimation is made and not in the year the original deduction was made.[63] Conversely, there is also authority for the need to return income in the event that revised estimates which reduce the estimated liability are made in subsequent years. Again, income is returned in the year in which the revised estimate is made, and not in the original year of deduction.[64]

Conclusions

4.21 It is suggested that treating estimated warranty costs in an analogous fashion to the currently accepted treatment of IBNR insurance claims will provide a workable solution to inevitable under- and over-statements of expenditure.

4.22 In changing to such a method it may be necessary for taxpayers to recognise estimated costs for the previous income year to ensure that the deduction for the first year is not over-stated. Issues of re-estimation of anticipated warranty costs may also arise. Judicial dicta suggest that these adjustments should be made in the year of re-estimation.

5. Stand-alone warranties

5.1 As seen, the Privy Council disagreed with the approach taken by the Court of Appeal. The case was resolved in favour of the taxpayer on the basis that the warranty costs were deductible under section BB 7. The Privy Council considered that there was no basis on which to reach a similar result by delaying the recognition of income.

5.2 However, the Privy Council thought that a different result would follow as to income recognition had there been a separate, identifiable charge for MMNZ's warranty. The Privy Council noted (at page 12,356):

> If MMNZ had actually made a separate charge for the warranty, there would be no difficulty about treating that income as earned over the period rather than at the moment of sale.

5.3 In practice, "stand-alone" warranties (or guarantees) are often offered by manufacturers and retailers. This may be the only contractual warranty/guarantee offered, or it may be an "extended" warranty offered in addition to a "built-in" (a MMNZ type) warranty. Customers decide whether to take advantage of the stand-alone warranty and must pay consideration in addition to the price of the goods for the warranty.

5.4 As discussed earlier, some warranties will be in similar terms to the MMNZ warranty, i.e. warranting against inherent defects appearing in the parts or workmanship of the goods sold within a specified period. But, a warranty may be wider in its terms; for example, the party providing the warranty agrees to keep the goods sold in "good working order" for the term of the warranty. In this way, some warranties may be more in the nature of a service agreement for a stipulated period, i.e. agreeing to service and maintain the goods for that period.

Stand-alone warranties in the nature of service contracts

5.5 In so far as a warranty is more in the nature of a service contract, the Privy Council's observation that the warranty income, in cases where full payment is made at the outset, should be spread over the period of the warranty will generally apply. This is an application of the principles laid down in *Arthur Murray (NSW) Pty Ltd v FCT*.[65] In *Arthur Murray* the High Court of Australia accepted that payments made in advance for future dance lessons were not derived until the lessons were taken. In broad terms, the amounts received had not "come home" because they were only earned as the lessons were given, and there was a possibility that some or all of the amounts received would have to be repaid as damages if the lessons were not provided.

5.6 Of relevance here, *Arthur Murray* has been applied in at least two cases dealing with maintenance contracts. In an Australian decision *Case* C86[66] the taxpayer was required to spread income received under a one year contract to maintain and repair plant over the period of the contract. In the Taxation Review Authority decision *Case* E8[67] the taxpayer was permitted to spread income received to maintain garden memorials over the years the taxpayer was obligated to perform the maintenance services.

5.7 The underlying reasoning in these cases is that income is not derived until the taxpayer has done all that is necessary to earn the sum received. These cases show that the reasoning in *Arthur Murray* may extend to contracts which do not involve the provision of a particular number of goods or services.

This will be the case for most service contracts and warranties in the nature of service contracts.[68]

5.8 This also accords with Inland Revenue's general acceptance that moneys received upfront for television servicing contracts may be spread over the period of the contract.[69]

Stand-alone warranties against inherent defects

5.9 However, Inland Revenue considers that it is doubtful whether income received for a stand-alone warranty to remedy inherent defects can be spread over the term of the warranty. In the case of warranties of that type there is an argument that income is derived at the time the warranty is entered into. In terms of the reasoning in *Mitsubishi*, the service provided under the warranty, i.e. the obligation to remedy inherent defects, arises at the time the warranty is entered into. This type of warranty is distinct from a warranty more in the nature of a service contract which envisages that services will be provided on an ongoing basis over the term of the warranty.

5.10 For these reasons, the Privy Council's statement may not be correct in so far as it applies to stand-alone warranties that warrant against inherent defects. The Privy Council decision focussed on the timing of deductions. It did not consider in any detail the issues relating to the recognition of income. In particular, it did not address the issue as to whether a taxpayer seeking to spread income under a stand-alone warranty is also entitled to claim estimated warranty costs at the time of entering into the warranty.[70] It is arguable that had the Privy Council considered this issue in detail, the Privy Council may have reached a different, and less generalised statement, on the recognition of income for stand-alone warranties.

5.11 The issue of recognition of income under stand-alone warranties against inherent defects remains open. It is arguable that the better view is that taxpayers must return all the warranty income in the year the warranty is entered into. However, taxpayers may in appropriate cases also be entitled to take a deduction for reasonably estimated future warranty expenditure in accordance with *Mitsubishi*.

5.12 In the case of warranties more in the nature of service contracts, taxpayers will be permitted to spread warranty income over the period of the warranty. However, taxpayers will generally not be able to make deductions for estimated future warranty expenditure because that expenditure has not been "incurred" in terms of *Mitsubishi*. It is contingent upon whether, and to what extent, the taxpayer is required to provide servicing under the warranty.

5.13 Whether a particular stand-alone warranty is a warranty against inherent defects or a maintenance contract will depend on the particular contractual arrangements between the parties. It is acknowledged that some stand-alone warranties may involve an obligation to remedy inherent defects *and* provide ongoing servicing, e.g. the warranty agreement may provide for a warranty period and for a period of servicing after the expiry of the warranty period. In such cases it may be necessary to identify the fees payable for the different obligations and treat those fees differently, i.e. the fees relating to the "true" warranty being returned at the time of entering into the warranty; the fees relating to the ongoing servicing being spread.[71]

5.14 In such cases an estimate for future warranty costs will need to differentiate between costs relating to repair of inherent defects and other costs provided under the servicing aspect of the contract. In accordance with *Mitsubishi*, a deduction for only those future warranty costs that relate to the repair of inherent defects will be available at the time of entering into the contract.

PART C Application of section EF 1

1. Introduction

1.1 Section EF 1 (section 104A of the *Income Tax Act* 1976) is a qualification to the general position under the Act that outgoings relating to the gaining or production of assessable income are deductible when incurred. Although a deduction is allowed for the expenditure incurred, under section EF 1 assessable income is deemed to include the amount of the unexpired portion of any "accrual expenditure" that relates to future income years. Section EF 1 modifies the section BB 7 "incurred" test where expenditure is "incurred" in one year, but the benefit extends beyond that year. Its effect is to progressively write down the expenditure over later years.

1.2 Section EF 1 was not argued before the courts in *Mitsubishi*. A number of commentators have raised the possibility that section EF 1 may apply to the facts of the case.[72] That is to say, although the Privy Council established that the estimated warranty costs were deductible under section BB 7, that deduction, or a part of it, may still have to be added back under section EF 1. If this is the case, it will have the practical effect of largely reversing the timing advantage that *Mitsubishi* affords taxpayers who are able to rely on the decision.

1.3 Inland Revenue is aware of the doubt surrounding the application of section EF 1 and the concern of taxpayers that the Commissioner may seek to apply the section in this context. As a first stage, this paper addresses some of the technical arguments that arise in the course of considering the potential application of section EF 1 to the facts of the case. This analysis considers the "plain language" of the provision and then the legislative background to its enactment. This approach is considered to be consistent with the leading New Zealand case on the interpretation of taxation legislation, *CIR v Alcan New Zealand Ltd*.[73]

1.4 No firm conclusions are reached in this paper as to the application of section EF 1. Inland Revenue welcomes submissions on this issue.

2. Legislation

2.1 Section EF 1 states:

> **EF 1(1)** Where any person has incurred any accrual expenditure, that expenditure shall be deductible when it is incurred in accordance with this Act but the unexpired portion (if any) of that expenditure shall be taken into account in ascertaining the assessable income of the person for the income year in which that expenditure is incurred and subsequent years.
>
> **EF 1(2)** The amount of the unexpired portion of any amount of accrual expenditure of any person at the end of an income year shall be included in the assessable income of the person for the income year and such amount shall be deductible in the following year.

EF 1(3) For the purposes of this section the Commissioner may determine whether and to what extent any person or class of persons shall not be required to comply with this section in relation to any accrual expenditure (not being expenditure incurred by way of monetary remuneration for services that have been performed) incurred by the person, having regard to—

(a) The nature and amount of the kinds of accrual expenditure regularly incurred by the person or class of persons:
(b) The nature and size of the activity giving rise to the item or items of accrual expenditure incurred by the person or class of persons:
(c) The costs of the person or class of persons in complying with this section in relation to the accrual expenditure incurred by the person or persons:
(d) Whether, in respect of that person or class of persons and the item or items of accrual expenditure, the difference between expenditure that is determined under this section (other than this subsection) and expenditure that would be deductible if the discretion given to the Commissioner under this subsection were exercised, is not a material amount.

EF 1(4) The Commissioner may at any time cancel any determination made in respect of any person or any class of persons under subsection (3).

EF 1(5) The amount of the unexpired portion (if any) of any amount of accrual expenditure of any person to be taken into account in any income year shall be—

(a) Where the expenditure relates to the purchase of goods, the amount of the expenditure incurred on goods not used in the production of assessable income:
(b) Where the expenditure relates to payment for services, the amount of expenditure incurred on services not performed:
(c) Subject to subsection (8), where the expenditure is incurred by way of monetary remuneration for services that have been performed, the amount of the expenditure that has not been paid in the income year or within such further period as is specified in subsection (6):
(d) Where the expenditure relates to a payment for, or in relation to, a chose in action, the amount that relates to the unexpired part of the period in relation to which the chose in action is enforceable.

EF 1(5A) For the purposes of this section, any payment to which section CB 12(1) applies is deemed to be expenditure incurred by the payer as payment for services performed in the year or years in which the recipient of the payment is expected to incur the expenditure to which the payment relates.

EF 1(6) For the purposes of subsection (5)(c), monetary remuneration shall be deemed to have been paid by a person in a particular income year if—

(a) In the case of any employee (other than a shareholder-employee) of the person, the monetary remuneration was paid to the employee—

(i) In the income year; or
(ii) Within 63 days after the end of the income year; or

(b) In the case of any person who, in relation to the person (being a company) is a shareholder-employee, the monetary remuneration was paid to the shareholder-employee—

(i) In the income year; or
(ii) Not later than the 31 March that, in relation to the person (being a company) and the income year, is the latest date to which the time for the furnishing of

the return for that income year may be extended under section 37(5) of the Tax Administration Act 1994.

EF 1(7) In this section—

'Goods' means all real or personal property; but does not include choses in action or money:

'Services' means anything which is not goods or money or a chose in action.

EF 1(8) For the purposes of paragraph (c) of subsection **(5)**, no expenditure referred to in that paragraph shall be treated as accrual expenditure where the expenditure—

(a) Was incurred before the 1990–91 income year; or
(b) Was incurred in the 1990–91 income year in relation to any holiday pay to which an employee (not being a shareholder-employee) of the person incurring the expenditure was entitled or would become entitled.

2.2 "Accrual expenditure" is defined in section OB 1. Broadly, it means any expenditure that is deductible under the Act other than that incurred in the purchase of trading stock, or in respect of a specified lease or any financial arrangement. Section OB 1 states:

'Accrual expenditure', in sections EF 1 and FE 4, in relation to any person, means any amount of expenditure incurred on or after 1 August 1986 by the person that is deductible under this Act, or was deductible under the Income Act 1976, other than expenditure incurred—

(a) In the purchase of trading stock; or
(b) In respect of any financial arrangement; or
(c) In respect of a specified lease, or a lease to which section EO 2 applies; or
(d) Under a binding contract entered into before 8.30 p.m. New Zealand Standard Time on 31 July 1986:

2.3 Section EF 1(1) applies where any person has "incurred" any accrual expenditure. That expenditure is deductible when it is incurred, as determined under the Act generally. This means that the common law test of what is meant by "incurred" for the purposes of section BB 7, also applies to section EF 1 and, importantly for these purposes, section EF 1 potentially applies to both paid and unpaid accrual expenditure.

2.4 Although section EF 1 is often described in terms of being a "pre-*paid* expenditure" provision, it seems fairly clear that its application is wider. This follows from the terms of section EF 1(5)(c). Under section EF 1(5)(c), the unexpired portion of any expenditure that is monetary remuneration for services performed is the amount of expenditure that *has not been paid* in the income year (or the extended period under subsection (6)). Section EF 1(5)(c) clearly applies to both paid and unpaid expenditure. Because sections EF 1(5)(b) and (d) expressly refer to "payment", it might be argued that this limits the application of these subsections to expenditure which has been both incurred and paid for. However, it is also possible to interpret the reference to "payment" in those subsections as referring to pre-payments *and* future payments. Section EF 1(5)(c) supports such an interpretation. There is nothing in section EF 1 to suggest that it applies in a more limited fashion to services and choses in action. Therefore, it is suggested for the purposes of section EF 1 that "incurred" expenditure includes both unpaid and paid expenditure (although effectively only the latter may be deducted in the case of monetary remuneration).

2.5 Section EF 1(1) provides that although accrual expenditure that has been incurred is deductible when it is incurred in accordance with the Act, the unexpired portion (if any) of that expenditure must be added back as assessable income.

2.6 Section EF 1(5) determines the amount of the unexpired portion of any accrual expenditure. The amount depends on the character of the expenditure, i.e. whether it relates to goods, services, monetary remuneration, or a chose in action.

3. Application to deductions for warranty costs

3.1 The Privy Council in *Mitsubishi* held that MMNZ had "incurred" a liability to meet future warranty costs arising out of sales of vehicles in the relevant income year and was entitled to make a deduction equivalent to a reasonable estimation of those costs.

3.2 The expenditure in question was the estimated warranty costs. This expenditure falls within the definition of "accrual expenditure". (It has not been incurred in the purchase of trading stock, nor in respect of any specified lease or financial arrangement.[74]) Under section EF 1 the "unexpired portion" of any accrual expenditure must be added back. Deciding whether there is any "unexpired portion" requires consideration of section EF 1(5). Section EF 1(5) determines what is meant by the "unexpired portion" of any amount of accrual expenditure with reference to the *type* of expenditure. That is, in this context, whether the expenditure relates to the purchase of goods, payment for services, or payment for, or in relation to, a chose in action.[75]

3.3 Before considering the specific wording of sections EF 1(5)(a), (b) and (d), it is perhaps worthwhile to briefly consider the meaning of "relates to". Those words appear in each of the subparagraphs mentioned and are directly relevant to this enquiry in so far as it might be suggested that they broaden the scope of the application of section EF 1.

"relates to"

3.4 The meaning of "relates to" in section EF 1 appears not to have been directly considered by any New Zealand court. However, the words "relates", "in relation to", and "relating to" have been considered by the courts, both here and overseas.

3.5 A leading case on the meaning of "in respect of or *in relation to*" is the Court of Appeal decision *Shell New Zealand Ltd v CIR*.[76] In that case the Court of Appeal considered the meaning of the phrase "in respect of or *in relation to* the employment" in the definition of "monetary remuneration" and "extra emolument" in section 2 of the *Income Tax Act* 1976. The words "in respect of or in relation to" were held to be "words of the widest import". However, it is suggested that this conclusion may not be particularly useful in interpreting the meaning of "relates to" in section EF 1, given that where the words "in relation to" appear as a compound term with the words "in respect of", it is arguable that their scope is naturally broader.

3.6 In *Department of Internal Affairs v Poverty Bay Club Inc*,[77] the District Court held that the meaning of the word "relates" in section 2(c) of the *Antiquities Act* 1975 is the ordinary meaning of the word, i.e. "to have a connection or to establish a relationship with".

3.7 In the recent High Court decision *Picture Perfect Ltd v Camera House Ltd*,[78] Barker J considered the potential scope of the word "relates" as it appears in section 29(1)(c) of the *Commerce Act* 1986. Barker J did not have to draw any final conclusions on this point as the issue before him was whether to accept a strike-out application. However, he acknowledged that the interpretation of "relates" in this context could involve either a flexible or a restrictive approach. He noted that it had been suggested that the preferable interpretation was that the "relates to" concept should be given a "liberal view" (i.e. to extend to situations with only an indirect connection) to reflect the underlying legislative intention.

3.8 The Supreme Court of Canada also gave a wide interpretation to the words "relating to" in *Slattery (Trustee of) v Slattery*.[79] The Court considered the meaning of "in respect of proceedings *relating* to the administration or enforcement" of the *Income Tax Act*. Iacobucci J gave "relating to" the same meaning as

"in respect of" and "in connection with". The Court considered that these words suggested a wide, rather than a narrow interpretation of the section containing those words. However, a narrower interpretation of "relating to" was preferred by McLachlin J in his dissenting judgment. He was of the opinion that the context and jurisprudence concerning the section within which the phrase was used determined its meaning and indicated a narrower construction.

3.9 From this analysis it is suggested that "relates to" generally means that one thing has a connection or establishes a relationship with some other thing. However, the scope of this connection will depend on the statutory context in which the *relating to* concept appears.

Section EF 1(5)(a) — Goods

3.10 Section EF 1(5)(a) deals with expenditure that "relates to the purchase of goods". "Goods" are defined as meaning all real and personal property, but not including choses in action or money.

3.11 In broad terms, this section potentially applies where a taxpayer has purchased goods for which a deduction may be claimed under section BB 7. To the extent that the goods have not been *used in the production of assessable income* at year-end, the amount of the expenditure which relates to those goods must be added back. A simple example would be a farmer who purchases and pays for 100 sacks of fertiliser during the income year. At year-end, only 50 sacks have been used on the farm (i.e. used in the production of assessable income). The taxpayer is permitted to take a deduction for the full costs of the fertiliser, but under section EF 1 must add back half that cost as assessable income.

3.12 Section EF 1(5)(a) applies where the expenditure in question relates to the purchase of goods. On one basis, the application of this provision could be interpreted as potentially covering three types of expenditure i.e.:

- the purchase price of goods acquired for, and paid (or to be paid) for by, the taxpayer;
- the purchase price of goods acquired by a third party, but paid for (or to be paid for) by the taxpayer;[80] and
- expenditure paid for (or to be paid for) by the taxpayer, being ancillary, or *relating to*, the purchase of any such goods.

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On this basis, the estimated warranty costs incurred by MMNZ would not fall within the provision. The expenditure is not payment for the purchase of goods by MMNZ, or by any third party (customers paying for the purchase of their own vehicles). Nor does the expenditure relate to any such purchase.

3.13 It is acknowledged that an alternative, and potentially wider, interpretation of section EF 1(5)(a) can be made. It is perhaps arguable that the inclusion of the words "relates to" extends the provision to apply to *any* expenditure that has a connection with the purchase of goods, regardless of whether *the taxpayer* has paid, or is to pay, for the purchase of those goods. It is only necessary that the expenditure relates to, in a general sense, the purchase of goods; provided that the expenditure is deductible under section BB 7, it will potentially fall within section EF 1(5)(a). Taking this wider approach, it can then be argued that the warranty expenditure which MMNZ incurred *relates* to the purchase of goods, i.e. the purchase of vehicles by consumers.

3.14 In *Commissioner of Customs and Excise v Ingram* [1949] 2 KB 103, the Court of Appeal considered whether a "person concerned with the purchase ... of goods" could be required to furnish information *relating to* a sale of goods by that person to others. That case concerned section 20(3) of the *Finance Act* 1946 (UK) which dealt with purchase tax and provided:

> Every person concerned with the purchase or importation of goods or with the application to goods of any process or manufacture or with dealings with imported goods shall furnish to the Commissioners

> within such time and in such form as they may require information relating to the goods or to the purchase or importation thereof....

3.15 The Commissioner contended that the phrase "information relating to the purchase thereof" required the taxpayer to not only furnish information about goods purchased by him, but also information relating to the sale of those goods by him to others. The Commissioner argued that the phrase must be read in the context of, and having regard to, other sections of the Act which imposed purchase tax.

3.16 The Court accepted the Commissioner's arguments. The Court looked to the definition of "purchase". For the purposes of the Act it was defined as meaning any contract which is a contract of sale within the meaning of the *Sale of Goods Act* 1893. This meant that purchase must be read in section 20(3) as applying to buyers and sellers. However, in reaching this decision the Court noted:

> It must, we think, be conceded that the drafting of the sub-section is not in any way felicitous: and ... it seems to us that a first and natural reading of its terms would confine 'purchase' to the purchase by the 'person concerned'.

3.17 It is not altogether clear if section EF 1(5)(a) is intended to apply only to expenditure relating to purchases of goods paid, or to be paid, for by the taxpayer seeking the deduction. However, in the light of *Ingram* the better view seems to be that the section is limited in this way. As seen, "relates to", and similar phrases, have generally been given a fairly broad meaning, although the breadth of that meaning tends to be influenced by the legislative context. If Parliament had intended to apply section EF 1(5)(a) to both purchases *and sales* it could have provided for this expressly. The better view of the meaning of "relates to" appears to be that it extends the provision to cover expenses ancillary to, or paid in connection with, the purchase of goods by the taxpayer, e.g. freight charges, or storage charges. But, it does not extend section EF 1(5)(a) to cover expenditure relating to the purchase of goods by a third party for which the taxpayer does not pay, or become obliged to pay, consideration for.

Goods — calculating the unexpired portion

3.18 If it is accepted that section EF 1(5)(a) only applies to the types of expenditure set out in paragraph 3.12 above, future estimated expenditure to meet warranty costs relating to goods *sold* by the taxpayer is not caught by this provision. Accordingly, there is no "unexpired portion" to add back.

3.19 Even assuming that section EF 1(5)(a) could also apply to expenditure relating to goods purchased by a third party (by virtue of the inclusion of the general words "relates to"), the section only applies to the extent that the goods in question have not been *used in the production of assessable income*. Section EF 1(5)(a) focuses on *use* and goods have not been used to produce assessable income until they have been applied or consumed in some way. (This argument would have more significance in a situation where the taxpayer sought a deduction for goods it had purchased, or would need to purchase in the future, but not yet "used" to meet future warranty claims.) The contrary view is that, from the perspective of a taxpayer offering a warranty, once the goods have been sold they have been *used to produce income* for that taxpayer, i.e. the sale proceeds. On this basis, there is also no unexpired portion of expenditure to add back.[82]

Section EF 1(5)(b) — Services

3.20 Section EF 1(5)(b) deals with expenditure for services. "Services" is defined as *anything* which is not goods, or money, or a chose in action. The ordinary meaning of "service" confirms its wide application. *The Concise Oxford Dictionary of Current English* 8th Ed Clarendon Press, Oxford (1991 reprint) defines "service" as:

> the act of helping or work done for another or for the community etc. **2** work done in this way. **3** assistance or benefit given to someone...**11 a** the provision of what is necessary for the installation

and maintenance of a machine etc. or operation. **b** a periodic routine maintenance of a motor vehicle etc. **12** assistance or advice given to customers after the sale of goods...— v. tr. **1** provide service or services for, esp. maintain. **2** maintain or repair (a car, machine, etc.)....**4** supply with a service.

3.21 Broadly, section EF 1(5)(b) potentially applies where a taxpayer has incurred expenditure for services for which a deduction may be claimed under section BB 7. To the extent that the services have not been performed at year-end, the amount of the expenditure relating to the unperformed services must be added back. A simple example would be where a taxpayer engages a consultant under a contract spanning two income years. The consultant is paid an upfront fee for the provision of his or her services over the term of the contract. The taxpayer is permitted to take a deduction for the full fee, but under section EF 1(1) must add back that part of the fee that relates to unperformed services.

3.22 Section EF 1(5)(b) applies where the expenditure in question relates to payment *for* services. Accordingly, it is suggested that, as for section EF 1(5)(a), the application of this provision may be interpreted as potentially covering three types of expenditure, i.e.:

- the cost of services supplied to the taxpayer and paid for by the taxpayer:
- the cost of services supplied to a third party, but paid for by the taxpayer:[83]
- expenditure paid for by the taxpayer, being ancillary, or relating to, the payment for any such services.

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3.23 Therefore, to determine if, and how, section EF 1(5)(b) might apply to the facts of *Mitsubishi*, it is necessary to ask whether any "services" have been provided, and whether "payment" has been made for those services by a taxpayer in MMNZ's position. Warranty claims by customers will generally involve the supply of services, i.e. vehicle repair work. Although the facts in different arrangements may vary, it is generally the case that those services are provided directly by dealers to customers. Dealers then seek reimbursement for the cost of providing those services from the distributor or manufacturer, e.g. MMNZ.

3.24 It may be arguable that dealers, in providing repair work to customers, also provide a "service" to their distributor/manufacturer (MMNZ) by honouring the terms of their dealership arrangement with that party. The service is the processing of warranty claims, including the provision of repair work. Alternatively, it might also be argued that the taxpayer in MMNZ's position pays dealers to provide repair services to customers.

3.25 It is suggested that it is fairly clear that the repair services provided by the dealers to customers, to the extent to which they are not paid for by the taxpayer seeking the deduction, would not come within this provision. Although it is possible to argue for an alternative and potentially wider interpretation of section EF 1(5)(b) based on the meaning of "relates to" (as was the case with section EF 1(5)(a)),[85] it is suggested that the reference to "for" in this provision strongly indicates that for the section to apply the taxpayer must be obliged to *pay for* the underlying services. This result is consistent with the preferred interpretation of section EF 1(5)(a) discussed above, i.e. that the section only applies where the taxpayer has *paid for* (or will be obliged to *pay for*) the goods in question. It is suggested that it is reasonable to assume that Parliament intended for there to be consistency between the various subparagraphs where the same words, i.e. "relates to", are used. For these reasons it is suggested that the better view is that section EF 1(5)(b) does not apply to the provision of repair services by dealers to customers, to the extent to which those services cannot be said to have been paid for (or will be paid for) by the taxpayer seeking the deduction.

3.26 Accepting that section EF 1(5)(b) does not apply to services provided to third parties and not paid for, or obliged to be paid for, by the taxpayer, the question becomes whether it could apply to the relationship between dealers and a taxpayer in MMNZ's position. The issue becomes whether it is possible to say that:

- the taxpayer has paid for, or is obliged to pay for, services supplied to it; or
- the taxpayer has paid for, or is obliged to pay for, the repair services provided to customers.

In either case it is arguable that section EF 1(5)(b) may apply to require the adding back of the future estimated warranty expenditure by the taxpayer.

Has the taxpayer paid for services supplied to it?

3.27 In most situations, a taxpayer in MMNZ's position requires dealers to process warranty claims and undertake certain repair services to fulfil obligations under warranties provided by dealers to customers. This will be in accordance with the dealers' responsibilities under their dealership agreements with the taxpayer. It might be argued that, to that extent, dealers do also provide a "service" to the taxpayer, i.e. repair work for a third party, but for the indirect benefit of the taxpayer. It is arguable that the taxpayer makes payment for those services in the form of the reimbursement of the cost of the repairs (and replacement parts).

3.28 Some support for this analysis is available in the Taxation Review Authority decisions *Case* R34[86] and the supplementary decision dealing with the same facts and taxpayer, *Case* S88.[87] Although those decisions concerned GST, they include an analysis of the relationships which may exist between customers, dealers, and distributors in the motor vehicle industry. In both cases the question was whether reimbursements for warranty repair costs made by the overseas manufacturing company to the objector, a New Zealand distributor (a party in approximately the same position as MMNZ in the chain of distribution), were subject to GST. In *Case* R34 the Commissioner had conceded the argument that there was no supply of any services by the objector to the manufacturing company. The argument focussed on whether the payments made by the manufacturing company to the objector were consideration for the supply of repair services by the dealers. On this basis the Commissioner lost. However, in *Case* S88 the Commissioner argued successfully that there was a supply of repair services by the objector to the manufacturing company. Barber DJ noted (at page 7,562) that the result of the respondent's approach is to construct three supplies out of the one set of repair work, namely: from the dealer (who did the actual physical repair work) to the objector; from the objector to the customer of that warranty work, for which consideration is in the purchase price of the car; and the supply of services from the objector to the manufacturing company.

3.29 These cases must be viewed with some caution given that they deal with the issue of whether consideration has been paid for the supply of services in the context of GST, and the facts differ from those in the Mitsubishi decision, e.g. in these cases the warranty was provided by the distributor to the customers.[88] However, they tend to support the conclusion that in some cases a dealer, in providing repair services to customers under warranties, also supplies services to a distributor who reimburses the dealer for the cost of those services. And, in addition, that a distributor who effects repair services through its agent in order to fulfil obligations under a warranty it provides to its dealers' customers, provides those repair services to the manufacturer who provides a warranty to that distributor.

3.30 However, the converse argument is that the services provided by dealers are *only* provided to customers, and not also to the party that reimburses the dealer for the cost of providing those services, e.g. MMNZ. On this basis, dealers merely fulfil the terms of their dealership agreements (and the underlying warranties) for which they are indemnified by a third party. They do not provide a *direct* service to the party that reimburses them for the cost of providing those services.

Has the taxpayer paid for services supplied to customers?

3.31 Even if it is accepted that no services have been supplied to, and paid for by, a taxpayer in MMNZ's position, section EF 1(5)(b) may still apply. It is suggested that the provision may apply if it can be shown that the taxpayer has *paid for* (or is obliged to *pay for*) the services supplied to customers, even if no service is provided to the taxpayer itself. However, the section will not apply if the relationship is not one of "payment for services", but rather reimbursement or indemnification of services provided to a third party.

3.32 Ultimately, the resolution of these issues in any particular case will require a close analysis of the terms of the relevant dealership arrangements, including establishing who provides the warranty and on what basis. This will involve establishing whether the taxpayer in question is paying *for* the services of dealers

under such arrangements, or paying *for* services to be provided by dealers to customers. To that extent it is suggested section EF 1(5)(b) may apply to require adding back of estimated future warranty costs. However, in some cases it may be that taxpayers are simply reimbursing or indemnifying dealers for fulfilling obligations under warranties, rather than there being any payment *for* services.[89] In such a case, on the basis of the above analysis, it is suggested that section EF 1(5)(b) would not apply.

Services — calculating the unexpired portion

3.33 To the extent that the expenditure incurred relates to payment for services which have not been performed, then that expenditure must be added back. Applied to the facts in Mitsubishi, this would mean adding back estimated costs to the extent that repair services have not been performed.

Section EF 1(5)(d) — Choses in action

3.34 Section EF 1(5)(d) deals with choses in action. A chose in action is not defined for the purposes of the section. Both "goods" and "services" are defined as not including choses in action.

3.35 A "chose in action" is an expression used "to describe all personal rights of property which can only be claimed or enforced by action, and not by physical possession".[90] A warranty is an enforceable right under a contract and as such is a chose in action.

3.36 Section EF 1(5)(d) applies to expenditure which *relates to* a payment *for, or in relation to,* a chose in action. Broadly, this section potentially applies where a taxpayer has incurred expenditure in relation to a chose in action for which a deduction may be claimed under section BB 7. To the extent that the expenditure relates to the unexpired part of the period of the chose, it must be added back. A simple example would be where a taxpayer enters into an insurance policy for a period that spans two income years. The taxpayer pays a lump sum premium for the policy. The taxpayer is permitted to take a deduction for the full premium, but under section EF 1(1) must add back that part of the premium that relates to the unexpired period of the policy.

3.37 Section EF 1(5)(d) applies where the expenditure in question relates to a payment for, or in relation to, a chose in action. On a similar basis as for sections EF 1(5)(a) and (b), the types of expenditure potentially within the provision may be identified as follows:

- the payment by the taxpayer for, or in relation to, a chose for the benefit of the taxpayer;
- the payment by the taxpayer for, or in relation to, a chose for the benefit of a third party; and
- expenditure paid for by the taxpayer, being ancillary, or *relating to*, the payment for any such choses in action.

3.38 As for sections EF 1(5)(a) and (b), because of the words "relates to", it is possible to argue that the payment for the chose in action does not need to be made by the taxpayer in question. It is enough if the expenditure merely *relates to* a payment made by a third party for a chose in action. However, again, it is suggested that the better view is that the inclusion of the word "for" requires that the expenditure be for (or in relation to) a chose in action paid for by the taxpayer; the chose being either for the benefit of the taxpayer or a third party. The words "relates to" must be read in the light of the word "for".

3.39 As for section EF 1(5)(b), this analysis then raises the question of whether a taxpayer in MMNZ's position can be said to have paid *for* a chose in action in terms of the estimated warranty expenditure. With regard to warranties, it is *the customer* that has the benefit of the warranty, i.e. the right to make a claim in the event of a defect appearing within the warranty period. It is the customer's chose in action, and not the taxpayer in MMNZ's position. On that basis it is suggested no payment is made *for* a chose for the direct benefit of the taxpayer. However, in certain cases it may be possible to argue that a payment is made for the customer's chose in action by a taxpayer in MMNZ's position. Again, whether this is the case in any particular situation will depend on the exact terms of the dealership arrangements (including the relevant warranty) and the basis on which payment is made by the taxpayer to dealers *vis-á-vis* the warranty obligations. It is

suggested that to the extent that payment is made *for* the underlying warranty, even though this will be for the direct benefit of customers and not the taxpayer, section EF 1(5)(d) may apply.

3.40 In addition, it is noted that, unlike sections EF 1(5)(a) and (b), section EF 1(5)(d) also includes the words "in relation to". As seen, the words "in relation to" tend to have been interpreted in a broad manner by the courts. By the inclusion of these words it is reasonable to assume (and, generally speaking, from a statutory interpretation perspective, it is necessary to assume) that Parliament intended to broaden the application of section EF 1(5)(d), when compared with sections EF 1(5)(a) and (b).[91]

3.41 A similar phrase, "for or in connection with", as it appears in section 26AB of the *Australian Income Tax Assessment Act* 1936 (which deals with payments for the grant or assignment of a lease) was considered in *Berry v FCT* (1953) 89 CLR 653. The Court in that case concluded that the words "for or in connection with" covered a payment received for something other than the main property in question, so long as the receipt of the payment had a substantial relation, in a practical business sense, to that property. This might suggest that the words "for or in relation to" are wide enough to cover a payment made by a taxpayer in MMNZ's position for warranty costs, in that although that payment may not be *for* the chose in action (i.e. the warranty) it is a payment made "in relation to" that chose. To that extent, section EF 1(5)(d) would apply to the estimated future warranty costs.

3.42 This interpretation of section EF 1(5)(d) requires reading the words "for, or in relation to" disjunctively, in that the section will apply even if the taxpayer has not made any payment *for*, or is obliged to make any payment *for*, the underlying chose in action. Provided that a payment has been made *in relation to* that chose, that is enough to come within the section. A narrower interpretation would be that for the provision to apply the taxpayer must have made payment for a chose in action, before any other payment made *in relation to* that payment is caught. However, it is suggested that the difficulty with this argument is that it tends to attribute the same meaning to the words "in relation to" and "relates to", i.e. expenses ancillary to the principal payment for the underlying chose. As noted, by including the words "in relation to", Parliament must have intended to extend the meaning of the provision. Unless it can be accepted that the words are simply otiose, it is suggested that the words "in relation to" must have a meaning distinct from the words "relates to". This may also tend to suggest that they are potentially wide enough to cover a deduction for future estimated warranty costs made by a taxpayer in MMNZ's position.

Choses in action — calculating the unexpired portion

3.43 To the extent that expenditure relates to a payment for, or in relation to, a chose, then the amount of expenditure incurred that relates to the unexpired period in relation to which the chose is enforceable must be added back. Applied to a taxpayer in MMNZ's position, this would require the taxpayer to add back expenditure incurred in relation to vehicles sold during the income year to the extent of the underlying unexpired warranty periods, e.g. if the estimated warranty costs for a vehicle sold on 1 December with a 12- month warranty were $1,200, then the full amount would be deductible at year-end (assuming a 31 December balance date) — all the expenditure having been incurred, but under section EF 1(1), $1,100, being that part of the expenditure which related to the unexpired warranty period, would have to be added back.

3.44 This result would not give matching in an accounting sense. It would defer in part the tax advantage resulting from the Privy Council decision, i.e. the ability to be able to claim a deduction for expenditure which is anticipated, but not yet paid.[92] It is worth noting that this application of section EF 1 reaches a similar result to that argued by MMNZ under the accruals rules, i.e. for the spreading of income earned by the giving warranties.[93] Under section EF 1 the available deduction would be spread, rather than the income derived from the giving of warranties. MMNZ's arguments on the basis of the accruals rules were rejected by the Court of Appeal, and not discussed by the Privy Council.

4. Interpretation of section EF 1

Case law

4.1 To date section EF 1 has only been directly considered in one case, being *Thornton Estates Limited v CIR*.[94] In that case the taxpayer company was a property developer that acquired land for development. In the year of acquisition it claimed a deduction for the cost of the land, developments costs, and other expenses which it argued were directly attributable to the utilisation of the land. The taxpayer maintained that it did not have to bring to account the value of the land, nor any expenditure on developing the land as a corresponding revenue item.

4.2 Hansen J held that, in the first instance, the taxpayer was entitled to a deduction for the expenditure under section BB 7. However, this was subject to the application of section EF 1. Section EF 1(5) applied to the purchase of goods, which included real property.

4.3 The taxpayer argued that under section EF 1(5)(a) the land (i.e. the good) had been "used" as soon as it had been applied for the production of assessable income. This meant that the total costs associated with the land could be taken as a deduction from the time the development commenced, even though the use was spread over a number of income producing years.

4.4 Hansen J rejected the taxpayer's argument and concluded that the land was not *used* in terms of section EF 1(5)(a) until the land was sold, i.e. it had produced assessable income — this treatment being analogous to the treatment of trading stock. In reaching this conclusion, Hansen J rejected the taxpayer's arguments for adopting the ordinary meaning of the word "use". Instead he was prepared to apply a scheme and purpose approach to the interpretation of section EF 1 (at page 12,245):

> In my view, it is correct to interpret this legislation in that manner. As was noted earlier, the purpose of the accrual regime was to achieve tax symmetry by the matching of expenditure and income. It seems to me that for the legislation to have the required effect, it is necessary to interpret and apply these sections in the manner the Commissioner has done in this particular case. To interpret 'use' in the manner Mr Martin urged me to would be to make the accruals regime pursuant to s104, if not totally ineffective, then very close to it.

4.5 Hansen J's judgment supports adopting a scheme and purpose approach to the interpretation of section EF 1, "which requires looking at it as a whole, rather than considering the language of the section in isolation" (at page 12,245). He suggests that the purpose of the section is to achieve matching of income and expenditure. It is submitted that this may not be strictly true. The purpose of the legislation appears to be to match the timing of deductions for expenditure with the benefit that flows from that expenditure (by the use of the goods, the performance of services or the expiry of the period of the relevant chose in action). Often, but not always, this type of matching will correspond with matching of, in an accounting sense, expenditure and income. However, the purposes are different and may lead to different treatments.

4.6 Notwithstanding this, it is acknowledged that *Thornton Estates* provides some support for interpreting section EF 1 in a way that is consistent with its scheme and purpose, i.e. the timing of deductions for expenditure with the benefit that flows from that expenditure. Applying such an approach to the facts in *Mitsubishi*, leads to the argument that section EF 1 should not apply because its application results in a mis-matching of the timing of the deduction (for warranty costs) with the benefit that flows from that expenditure (the sale of vehicles subject to warranties). This argument emphasises the link made in section EF 1(5)(a) (although not expressly in sections EF 1(5)(b) to (d)) to the "use" of the item and the production of income.

4.7 However, it is possible to take a contrary view, i.e. that section EF 1 requires the adding back of any expenditure to the extent that any item to which the expenditure relates has not been consumed (in the sense of: goods not used, services not performed or an unexpired period of a chose in action), regardless of whether, and to what extent, the item has produced assessable income as at the end of the relevant income year. In many cases this approach would lead to the same treatment as applies under a matching approach. Generally, the good, service, or chose in action only contributes to the income earning process by way of

consumption. However, there are situations where the two approaches diverge, i.e. where the good, service, or chose in action arguably produces income *before* it is consumed. Applying the matching approach to section EF 1, there would be no requirement to add back the relevant expenditure; adopting the consumption approach the expenditure would have to be added back to the extent that the relevant item had not been consumed in that income year.

Policy

4.8 Section EF 1 applies to all accrual expenditure incurred on or after 1 August 1986. PIB No 167 (December 1987), released shortly after the section's enactment, discusses the intended scope of the provision. At paragraph 14 it considers the mischief the section is designed to counter:

> As noted in the 1986 Budget many tax avoidance schemes depend upon deficiencies in the rules governing the timing of tax deductions and the derivation of income. Under section 104 of the Act a deduction is allowed for expenditure as it is incurred, i.e. when the taxpayer is under a legal obligation to make payment, not when payment is actually made. Given that a deduction could be taken in advance of actual payment there were obvious cashflow advantages in advancing the point in time at which an obligation to make payment was assumed. The new section 104A removes such timing anomalies by introducing a regime similar to the treatment of trading stock for expenditure that is wholly or partly attributable to income years other than the year in which the expenditure is incurred.

4.9 PIB No 167 includes a number of examples of expenditure relating to goods, services, and choses. In all the examples the expenditure is for goods, services, or choses which belong to, or are for the direct benefit of, the taxpayer seeking the deduction. There are no examples dealt with where payment is for goods belonging to, services supplied to, or a chose for the benefit of, another person.

4.10 In the case of goods, the focus appears to be on goods acquired *by* the taxpayer and applied to the production of assessable income *by* the taxpayer. In considering the scope of the "use" test, PIB No 167 states:

> A good is used in the production of assessable income when it is applied, consumed, put into operation, or otherwise employed, in the process that produces assessable income. It is not sufficient that it be available for use, and in particular it is not sufficient that the goods be available for examination or sale.

Although this extract does not refer expressly to the taxpayer seeking the deduction being the one that applies, consumes, puts into operation or employs the relevant good, the underlying rationale seems to be that it is that taxpayer's good. This is because of the reference to, logically, the taxpayer's "process that produces assessable income".

4.11 It is also of interest, as regards ascertaining the underlying scheme and purpose of the legislation, that paragraph 14 of PIB No 167 (set out above) likens the accrual expenditure regime to the trading stock regime (the approach taken in *Thornton Estates*).

Legislative background

4.12 Section EF 1 forms part of the accruals regime which was enacted in 1987. The *Consultative Document on Accrual Tax Treatment of Income and Expenditure* (October 1986) proposed a test of *delivery* for expenditure relating to the purchase of goods (rather than the current "use" test). At paragraph 14.2.1 it states:

> Expenditure incurred by a taxpayer on the purchase of goods will be deemed to relate to the income year in which the goods **are supplied or provided to the taxpayer**. (*Emphasis added*)

At that stage, at least in regard to "goods", it was clear that the goods in question must be acquired *by* the taxpayer seeking the deduction.

4.13 The *Consultative Document* also deals with services. The commentary does not make it clear whether or not the services must be performed for the direct benefit of the taxpayer seeking the deduction. However, the thrust of the discussion and the examples given suggest that this was the focus. At paragraph 14.2.2, dealing with "services", the following comments are made:

> Expenditure incurred by a taxpayer on services will be deemed to relate to the income year in which the services are provided. Where the expenditure is for services to be provided in more than one income year, the expenditure related to each income year will be determined on the basis of the fair market value at the date the expenditure is incurred for (sic) the services provided that year. A written statement **from the supplier of the services to the purchaser** will normally be accepted as sufficient evidence of the amount of the total expenditure relating to the services in each year.
>
> ...
>
> **Expenditure incurred on contingent service contracts (i.e., contracts for the supply of services contingent upon certain events, such as a contract for the repair of equipment in the event that the equipment breaks down) is to be pro-rated over the period to which the contract relates.** (*Emphasis added*)

4.14 Although this extract does not expressly say that the services in question must be performed for the benefit of the taxpayer seeking the deduction, this seems a reasonable implication. The assumption is that the "purchaser" of the services is the taxpayer seeking the deduction. In the case of contingent service contracts, the assumption is that the taxpayer is the party which has paid for the benefit of the contract, e.g. to cover any breakdown of *its* equipment.

4.15 By the time of the Consultative Committee's Report of April 1987, the test for determining whether expenditure in relation to the purchase of goods was fully deductible had changed to a "goods used" test. As seen, this test based on use rather than delivery, means that it is now arguable that the goods do not have to be those of the taxpayer (arguably, payment need only relate to the purchase of goods by a third party). However, there is nothing in the report to suggest that the "use" test was intended to be wider in this respect. The focus is on a test analogous to the trading stock regime (i.e. a regime dealing with expenditure on stock acquired *by* the relevant taxpayer). Paragraphs 60 to 62 of Part II of the Report indicate that the emphasis was on consumable aids, i.e. non-capital goods used by a business in the production of assessable income which are not trading stock. The reference to consumable aids again suggests that the Committee had the purchase of goods by the taxpayer seeking the deduction in mind.

4.16 Paragraph 14.2 of the Consultative Report (October 1986) noted:

> [T]he new timing provisions will make certain categories of expenditure deductible in the later of the year in which the expenditure is incurred or the year to which the expenditure actually relates. There will therefore be a two-step test of deductibility which is more restrictive than the current 'incurred' test.
>
> ...
>
> Under the new rules, taxpayers will be required to recognise as income each year the amounts of specified categories of expenditure that they have incurred in that year or in prior years but which relate to a period after the end of the income year... These rules mean that a taxpayer will receive no net deduction for the specified categories of expense until the year to which the expenditure relates.

Although not completely clear, arguably, these statements might be interpreted as suggesting that the accrual expenditure regime's intended effect was to match the taxpayer's incurring of expenditure to the income years in which the taxpayer derives assessable income in respect of that expenditure.

Accrual expenditure determinations

4.17 Section EF 1(3) permits the Commissioner to make determinations for exemption from section EF 1. The current determination is Determination E10 which applies for the 1994/95 income year and all subsequent income years until the determination is cancelled. Paragraph (f) of the Schedule to Determination E10 exempts payments for equipment service contracts and warranties in the following terms:

> (f) Payment in respect of equipment service contracts or warranties where the consideration for the contract or warranty forms an inseparable and indeterminate part of the consideration for the asset or assets to which it relates.

4.18 Paragraph 3(d) of Determination E10 provides that for this exemption to apply, the goods in question must be in the possession of the person at balance date. Putting aside the issue of whether vehicles supplied by MMNZ could be "equipment"(which is not defined), this means that this exemption could not apply to MMNZ. The assets to which the service contract or warranty relate must be in the possession of the taxpayer seeking the deduction, i.e. in this case, MMNZ. A vehicle under warranty will be in the possession of the customer.

4.19 This also suggests that section EF 1 is not intended to deal with goods, services, or choses which belong to, or are for the benefit of, a person other than the taxpayer seeking the deduction.

5. Conclusions

5.1 As seen, arguments may be made that the words of section EF 1, in certain situations on facts analogous to those in *Mitsubishi*, are wide enough to cover expenditure incurred by a taxpayer in MMNZ's position. This is either because it relates to payment for services (which effectively means that the expenditure cannot be deducted until the warranty claim has been honoured by the performance of repairs), or because it is for, or in relation to, a chose in action. In the case of a chose, the expenditure must be spread over the period of the underlying warranty.

5.2 However, to reach a view that section EF 1 applies in such cases is arguably to ignore the scheme and purpose of the legislation, as demonstrated by the legislative background to the provision. It appears from the background to the legislation, and recent judicial interpretation, that the section is essentially aimed at achieving matching of the timing of the deduction with the benefit that flows from that expenditure. It is arguable that to apply section EF 1(5)(b) or (d) to the facts of the case, would result in a taxation treatment that differs from matching in those terms. As also acknowledged, the contrary view is that section EF 1 applies to add back any expenditure to the extent that it relates to items not consumed regardless of whether or not any "benefit" in terms of the production of assessable income has already resulted from such expenditure.

5.3 As previously indicated, no firm conclusions regarding the application of section EF 1 to the facts of *Mitsubishi* are reached in this paper. The aim has been to identify the key issues and canvas some of the arguments that may arise. As highlighted, the resolution of these issues may involve close analysis of the facts of particular cases. It may not be possible to make any general statement to the effect that section EF 1 does not apply to deductions for future estimated expenditure in situations analogous to those in the case. In addition, the facts in the case involved deductions for expenditure paid to third parties (dealers) in order to satisfy the taxpayer's obligations under its warranties. Inland Revenue recognises that different considerations may flow in terms of the application of section EF 1 where the taxpayer meets its obligations by carrying out its own repair services. As stated, Inland Revenue welcomes submissions on the potential application of section EF 1 which it knows to be of significant interest to taxpayers and their advisers.

PART D: Conclusion

Summary

1.1 *Mitsubishi* provides a restatement of the "incurred" test, permitting taxpayers in certain situations to make a deduction for estimated future expenditure for liabilities which will not be quantified and paid until later income years.

1.2 It is difficult to anticipate how widely the decision may apply. In general terms, it will always be necessary for taxpayers to identify an event which gives rise to liability occurring within the relevant income year before a deduction will be available. That is, an event analogous to the existence of inherent defects at the time of sale, or liability under the terms of a policy of insurance.

1.3 It will also be necessary for taxpayers to be able to make a reasonable estimate of estimated future expenditure before a deduction will be available. At this time it is difficult to set out anything beyond general guidelines as to what will, and will not, be acceptable evidence to support an estimation of future expenditure.

1.4 It is arguable that section EF 1 may have application in this area. The foregoing analysis suggests that section EF 1(5)(a) (expenditure relating to goods) will generally not apply. However, in certain situations it may be arguable that section EF 1(5)(b) (expenditure relating to services) applies to estimated future warranty costs. Section EF 1(5)(d) may also be relevant in some cases; particularly because of the inclusion in that subparagraph of the words "in relation to" which may broaden the application of the provision. If section EF 1 applies it will reduce the advantage taxpayers gain, based on the reasoning in *Mitsubishi*, in obtaining a deduction in the year in which expenditure is incurred, where that expenditure will not be paid until a later year or years. This is because section EF 1(1) will require that some, or all, of that expenditure is added back as assessable income.

1.5 Where taxpayers offer warranties, but can claim reimbursement of that expenditure under warranties or indemnities with distributors, wholesalers, or manufacturers, there is an argument under section DJ 1(c) that no deduction for estimated future warranty costs is available.

1.6 It follows from the issues raised in this paper that in the context of the *Mitsubishi* decision and related legislation a number of areas may possibly remain uncertain and/or potentially unworkable for both taxpayers and Inland Revenue. If this proves to be so, it is possible that any such matters may require clarification or correction by way of legislative amendment. Such matters are, however, beyond the responsibility of the Rulings Unit and the scope of this paper.

1. *Mitsubishi Motors New Zealand Ltd* v *CIR* (1993) 15 NZTC 10,163.
2. *CIR* v *Mitsubishi Motors New Zealand Ltd* (1994) 16 NZTC 11,099.
3. All references in this paper are to the *Income Tax Act* 1994. The judgment considered the equivalent provisions of the *Income Tax Act* 1976.
4. The issue as to how to calculate reasonably estimated costs was not argued or addressed in the High Court decision. The appeals from that decision proceeded on the basis that the taxpayer had made a reasonable estimation of the warranty costs, including its estimation on the basis of past years that approximately 63% of vehicles contained defects which would result in claims. The question of what will be accepted as a reasonable estimation is discussed at Part B, paragraph 3.
5. Section 51(1) of the *Income Tax Assessment Act* 1936. The Privy Council then goes on to note that the Australian legislation does not refer to "profit or gains".
6. The Privy Council cited *CIR* v *Glen Eden Metal Spinners Ltd* (1990) 12 NZTC 7,270 as an example.
7. This is consistent with the second proposition quoted from *Bisley*.
8. The Privy Council acknowledged that MMNZ was not a party to the warranty. However, because MMNZ agreed to indemnify the dealers against the cost of warranty claims, any obligation incurred by the dealers was simultaneously incurred by MMNZ.
9. It has been suggested that it is perhaps difficult to reconcile the Privy Council's view that it was able to look beyond the legal relationship created by the warranty with earlier authority. Previously the Privy Council has said that whether an outgoing was deductible turns on "the legal character" of the payment made (*Europa Oil (NZ) Limited* v *CIR (No 2)* (1976) 2 NZTC 61,066; 61,072) which would seem to preclude going beyond an analysis of the legal position refer: Bassett J "Deduction and Product Warranties" *CCH Tax Planning Report* (December 1995).
10. The Privy Council also referred to *Commercial Union Assurance Co of Australia Ltd v Federal Commissioner of Taxation* (1977) 14 ALR 651; 7 ATR 435. The Privy Council noted that both the *RACV Insurance* and *Commercial Union* cases were cited with

approval in the High Court of Australia decision *Nilsen Development Laboratories Pty. Ltd v Federal Commissioner of Taxation* (1980–1981) 11 ATR 505, 514.
11. Discussed further below at Part B, paragraph 3: insurance industry.
12. The *RACV Insurance* case involved third party insurance. Due to statutory obligations the taxpayer was required to indemnify regardless of notice. Having concluded that the taxpayer was entitled to make a deduction for reasonable estimates of the costs of claims incurred but not reported, Menhennitt J noted (at page 619):

> All I have said appears to me to apply to all forms of liability insurance although in the case of a policy under which a right of indemnity is subject to conditions such as the giving of notice there may well be a question whether a loss or outgoing is incurred before notice of a claim is given or before the insurance company by its conduct admits liability to indemnify its insured or whether on the other hand the loss or outgoing is incurred upon the happening of the events giving rise to the claim by the third person if liability to indemnify is subsequently acknowledged by the company.

The Privy Council reached the view that the notice requirement under MMNZ's warranty was not significant. This accords with the result in *Commercial Union* where the Australian Commissioner unsuccessfully attempted to argue that the decision in *RACV Insurance* could not be applied to situations where insurance policies contained notification requirements. However, it was found on the facts there that, except in very rare cases, it was commercially certain that claims would be paid whether or not the insured parties complied with the notice provisions. In the case of IBNR claims, the ability to deduct is limited to estimates of liability for insured events which are estimated to have happened within the income year. Under *Mitsubishi* the reasoning extends to manifestations of defects within the warranty period, rather than the relevant income year. The Privy Council justified this difference by characterising the event which triggers liability as being the sale of the vehicle including a defect, rather than the subsequent appearance of the defect.
13. McHugh J noted (in a judgment delivered separately from the majority) (at page 4,229):

> Although the results in [*RACV* and *Commercial Union*] appear eminently sensible, they were reached only by a strained application of the rules laid down in *James Flood* and *Nilsen Development Laboratories*. That sensible result can only be achieved by a strained application of those decisions must throw doubt on the validity of the principles which decided them.

14. See *ANZ Banking Group Ltd* v *FCT 27* ATR 559, per Hill J at page 568 which confirmed that the reasoning in *RACV Insurance* (and *Commercial Union*) is not confined to the insurance industry.
15. *Federal Commissioner of Taxation* v *James Flood Pty Ltd* (1953) 88 CLR 492, 506–507.
16. Deane J gave two hypothetical examples. The first was where a taxpayer is under a liability to pay $1,000 to Y if a rainfall of ten points is recorded at a particular place during a particular future period and is under a quite independent liability to pay $1,000 to Z if a rainfall of ten points is not recorded at that place within that period. He draws the conclusion that although from a jurisprudential perspective each liability is contingent, taken together a liability of $1,000 has been incurred because together the liabilities represent an inevitable obligation to pay $1,000 at the future time.

The second was where a contingency for all practical purposes is satisfied. He gives the example where a taxpayer acquires trading stock in exchange for a binding promise to pay $1 million on 1 July 2005 if, but only if, the population of Australia exceeds two thousand persons. Deane J concluded that for all practical purposes the taxpayer must be treated as having incurred the expenditure at day one, because the taxpayer has completely subjected himself to that expenditure and the contingency of not having to pay up is only theoretical.
17. (1977) 14 ALR 651; 7 ATR 435.
18. As a matter of logic, however, the fact that some owners might choose not to make a claim necessarily takes them outside the 63% estimate, which was based on past claims. What the Privy Council was implicitly saying was that the level of inherent defects was actually higher if it is accepted that there might be a few owners who have vehicles with defects that manifest themselves within the warranty period, but who do not make a claim.
19. This approach accords with ATO Ruling IT 2648: *Motor Vehicle Manufacturers, Distributors and Dealers: Demonstration Stock Valuation; Holdback Amounts and Warranty Obligations* (25 July 1991). That ruling also refers to free first service obligations, i.e. a vehicle dealer cannot defer the recognition of the sale proceeds as being attributable to the dealer's undertaking to provide a free first service.
20. Compare *Nilsen Development Laboratories*.
21. At page 12,353: "This is a nice distinction which can easily become a matter of language rather than substance and on which judicial views may differ; for example, see *CIR* v *Glen Eden Metal Spinners Ltd* (1990) 12 NZTC 7,270".

In *Glen Eden* the Court of Appeal was split two:one. Richardson J noted at page 7,217: "[I]n marginal cases the distinction between a defeasible liability under which a taxpayer is definitively committed, and a contingent liability under which it is not, may not be easy to draw. This is such a case."
22. That it is the correct accounting treatment is probably indisputable: refer brief of evidence (AP 165/92) of Professor DG Trow at paragraphs 17 to 40.
23. This is consistent with existing case law see: *FCT v James Flood Pty Ltd* page 506–507 and *Nilsen Development Laboratories* at page 510 per Barwick CJ and page 512 per Gibbs J. Commercial and accounting practice may assist in ascertaining the true nature and incidence of the item as a step towards ascertaining whether it answers the test laid down in the statute, but it cannot be substituted for that test. A recent New Zealand example of this principle is the High Court decision in *Horizon Homes Limited* v *CIR* (1994) 16 NZTC 11,064, 11,069 where the Court saw accounting treatment as merely the first point of inquiry.

24. For discussion of some of these cases: refer *CIR* v *Farmers' Trading Co Ltd* (1982) 5 NZTC 61,200 per Richardson J at page 61,205.
25. It may be more difficult to establish that the case applies to warranties given in respect of second-hand items because the warranty may not be directed specifically at defects present at the time of sale (refer below at Part B, paragraph 2.14 where *The Motor Vehicle Dealers Act* 1975 is discussed).
26. MMNZ's warranty only applied to defects appearing in the material or workmanship of any part of a vehicle. It expressly did not apply if the vehicle had been subjected to misuse, neglect or accident, or if loaded beyond its capacity, or otherwise operated in a way not recommended by the manufacturer.
27. What is meant by a "reasonable estimation" is discussed in more detail at Part B, paragraph 3.
28. Stand-alone service contracts and warranties are considered further below at Part B, paragraph 5.
29. Merchantable quality is not a defined term. Case law has established that it essentially requires that goods sold by description are merchantable in the sense of being of sufficient quality to be saleable under that description to a buyer with full and accurate knowledge of that quality and who is buying for the ordinary and normal purpose for which goods of that description are bought in the market: *Taylor* v *Combined Buyers Ltd* [1924] NZLR 627.
30. Section 7 of the *Consumer Guarantees Act* 1993 defines acceptable quality. The effect is that a supplier must ensure its goods are fit for the purpose for which those goods are commonly used; acceptable in appearance and finish; free from minor defects; safe and durable. Whether particular goods are of acceptable quality depends on whether a reasonable consumer would consider that the goods are acceptable.
31. "Defect" is a defined term see: section 2(1) of the *Motor Vehicle Dealers Act* 1975.
32. Large retail stores may be examples of this type of taxpayer.
33. In the case reasonable estimates of future warranty costs related to particular vehicle models.
34. *HW Coyle Ltd* v *CIR* (1980) 4 NZTC 61,558, 61,567.
35. *Yeoman Credit Ltd* v *Latter and Another* [1961] 2 All ER 294, 296.
36. This was the case with the franchised dealers who purchased vehicles from MMNZ. The case did not address the issue as to whether, and to what extent, MMNZ was in turn able to seek indemnification from its Japanese parent company which manufactured the vehicles it assembled.
37. Refer ATO Ruling IT 2648 (25 July 1991) at paragraph 39. Doubt has been cast on this Ruling by Australian commentators both before and after *Mitsubishi*. Refer for example: Burton M, "Cases on 'incurred' in sec 51(1)" *CCH Journal of Australian Taxation* (December 1991/January 1992) 22, 27 and *CCH: Federal and State Tax News: "Tax Week"* (22 December 1995) at page 1,061.
38. As a matter of Inland Revenue practice there are some exceptions to the principle that provisions and reserves are not deductible. Refer *Technical Rulings* at paragraphs 20.50.1 to 20.50.2.7 re airline overhauls, discount reserves, maintenance reserves. Inland Revenue anticipates that these practices will be reviewed in the light of the Privy Council decision.
39. The Commissioner's arguments focussed on the "incurred" test.
40. As stated, the validity of MMNZ's "reasonable estimation" of future warranty costs for the relevant period was not argued before the courts.
41. Refer Proofs of Evidence (AP 165/92) of Craig Pinny and George Drummond.
42. MMNZ considered that the expenses actually paid in the income year to 31/12/88 predominantly related to vehicles sold in the last five months of the previous income year and the first seven months of that income year.
43. Again, this period was used because MMNZ's "analysis" had revealed that for most of the vehicles sold, the bulk of the warranty claims would be made within the first six months of sale. Put another way, for most vehicles sold between 1/1/88 to 30/6/88, most of the warranty claims would have already been made by 31/12/88. The witness's brief states: "This is not, of course, an exact calculation, because the provision in fact applies to all vehicles sold in the year of account, and not just those sold in the last 5 months. MMNZ's experience however has been that this formula for estimating the warranty provision does provide a reasonably accurate estimate of the actual expenses which will be incurred...".
44. The distinction between factory and non-factory costs is not spelt out in the evidence. It is assumed that factory costs are those incurred in putting right defects arising from assembly (labour) errors. The non-factory costs are those relating to parts.
45. The significance of "back to back" warranties and indemnification is discussed further at Part B, paragraph 2: section DJ 1(c).
46. Shewan J, "Derivation and Deductions Revisited — The Mitsubishi Decision" NZSA 1994 Tax Conference at page 32; Smith N: *The Sunday Star Times* (15 October 1995), "Warranty decision worth wait"; Martin D: *New Zealand Herald* (14 October 1995), "Mitsubishi warranty case tests future expense claims".
47. The relevance of reasonable and reliable estimates has recently been considered in the context of income derivation of compensation payments under business interruption insurance. Refer *CIR* v *Soma President Textile Ltd*; *CIR* v *New Zealand Knitting Mills Ltd* (1994) 16 NZTC 11,313, 11,319 and *Egmont Co-operative Dairies Ltd* v *CIR* (1994) 16 NZTC 11,006, and on appeal (1996) 17 NZTC 12,536.
48. 27 ATR 559, 571–573.
49. [1912] AC 443, 454.
50. As to what constitutes a reasonable estimate also refer: *Southern Pacific Insurance Co (Fiji) Ltd* v *CIR* (1986) STC 178 (PC); *Southern Railways of Peru Limited* v *Owen* [1957] AC 334, 357; *Case* W61 89 ATC 558 c/f. *Horizon Homes Ltd* v *CIR* (1994) 16 NZTC 11,064.
51. The High Court of Australia refused both the Commissioner and the ANZ Bank leave to appeal against the Full Federal Court decision. Refer *CCH Tax Week* Issue 41, 23 September 1994, 661.
52. It has been suggested by one commentator that a failure to make a deduction in the year of sale will mean that no deduction is available in the year that the cost is paid. Refer Richards R, "The Mitsubishi Motors case — Implications for all Australian businesses" *Butterworths Weekly Tax Bulletin* No 51 at 827.
53. This approach to the calculation of incurred liabilities payable in future years was recently confirmed by the Full Federal Court of Australia in *Burrill* v *FCT* 96 ATC 4,629. The Court noted that it is a fundamental principle of Australian income tax that rights to receive money and obligations to pay money are taken into account in calculating income and outgoings, gains and losses, at their nominal value. Where an accruals taxpayer brings to account a loss or outgoing incurred even though it may not be defrayed,

discharged or borne for some time, the amount brought to account is the nominal value of the loss or outgoing at the time it is incurred, and not its actual value at that time. The taxpayer does not suffer a reduction in the amount of a deduction otherwise allowable by reason that the present value of the loss or outgoing at the moment it is incurred is less than the nominal amount of the money required to discharge it sometime in the future (refer at pages 4,632 and 4,633).
54. The evidence produced by MMNZ illustrates this. The warranties in question ran from 12 months from the date of sale by the dealer to the customer and not from the earlier date of sale by MMNZ to the dealer. Therefore, all the cars sold by MMNZ in the 12 months to 31/12/88 would not necessarily be sold by dealers. The warranty periods for those vehicles would not even commence until after the end of the income year of sale. Also, in cases where an inherent defect manifests itself within the 12-month period and continues to do so thereafter, the warranty continues to apply to the vehicle until the defect is completely rectified. This may be several years after the expiration of the warranty period.
55. *RACV Insurance* at pages 618 and 627.
56. Refer form IR 44B. A similar method has also been adopted for dealing with discount reserves. Refer *CCH: New Zealand Income Tax Law and Practice* Volume 3 at paragraph 15-184 and *Technical Rulings* at 20.50.1.
57. [1986] STC 178.
58. ATO Ruling IT 2663 *Income Tax: Basis of Assessment of General Insurance Activities* (20 December 1991) at paragraphs 136 to 139.
59. Although, possibly subject to time bar. However, see section BB 5(3).
60. See *W S Jackson* v *The British Mexican Petroleum Co Ltd* [1932] 16 TC 570.
61. There is perhaps an argument, contrary to this strict interpretation, that the courts in the insurance industry cases were not saying that any particular amount had been "incurred"; they were merely saying that *an* amount had been "incurred", a reasonable estimate of which they would accept provided that the "rolling method" to deal with adjustments was adopted by the taxpayer.
62. See ATO Rulings IT 109 (originally issued 16 May 1975 and re-issued 24 May 1984) and IT 110 (originally issued 28 October 1977 and re-issued 24 May 1984). The ATO offered a concession on the basis of the *Commercial Union* case to insurance companies claiming an IBNR deduction as a separate item for the first time. The ATO accepted that it was not necessary for those taxpayers to deduct a notional amount for IBNR reserves which should have been claimed in the previous year because, like Commercial Union, such taxpayers would probably have been overestimating their OCR claims to compensate for not being able to make IBNR deductions in any event.
63. *RACV Insurance* v *FCT* 4 ATR 610, 618; *Commercial Union* v *FCT* 7 ATR 435, 448. Also refer to NZSA Financial Reporting Standard No. 7 (1994): Standard 5, paragraphs 5.21 and 5.22 dealing with changes in accounting estimates, which support adjustments being made in the year the need for the adjustment is recognised.
64. See *Commonwealth Aluminium Corp Ltd* v *FCT* 77 ATC 4,151, 4,161 and *International Nickel Australia Limited* v *FCT* 7 ATR 739; 743, 751 and 755.
65. (1965) 114 CLR 314. However, note that the ATO considers that even when an express apportionment between vehicle and warranty is made in the sale price, *Arthur Murray* does not apply. Refer ATO Ruling IT 2648 at paragraph 37. See *CCH: New Zealand Income Tax Law and Practice* at para 15-184 for an example of income spreading as applied to TV servicing contracts.
66. 71 ATC 385.
67. (1981) 5 NZTC 59,042.
68. The Australian Commissioner of Taxes acknowledged this interpretation of *Arthur Murray* in a statement issued after the decision. Refer *CCH: Australian Federal Reporter* at paragraph 12-005. However, compare the approach taken in TR 93/20 dealing with warranty and maintenance agreements sold by computer suppliers, and ATO Ruling IT 2638.
69. Refer *CCH: New Zealand Income Tax Law and Practice* at paragraph 15-184.
70. Accounting treatment would not favour such an approach as there would be no matching of income and expenditure.
71. Refer ATO Ruling TR 93/20 at paragraphs 28 to 31.
72. For example see: Phillips C, "Timing of Deductions — Mitsubishi Motors" *Current Taxation Butterworths* (27 April 1994); Shewan J (*supra*) at page 38; TEO Newsletter No 111 at page 4.
73. (1994) 16 NZTC 11,175. *Alcan* stands for the principle that it is fundamental to statutory interpretation that words are given their ordinary meaning. If, however, the words are capable of more than one ordinary meaning and the object of the legislation is clear, then the words must be given "such fair, large and liberal construction" as would best ensure the attainment of the object of the relevant Act.
74. The question of whether the warranty was a financial arrangement was considered by the Court of Appeal. That Court reached the view that although a contract of sale which includes an indemnity in respect of conditional obligations under warranties to be performed (at a cost) in the future came within the broad reach of para (b) of the definition of "financial arrangement", the fact that the warranty was an integral part of an agreement for sale and purchase of property meant that the entire arrangement was an "excepted financial arrangement" and therefore outside the accruals regime.
75. Section EF 1(5)(c), relating to expenditure incurred by way of monetary remuneration for services, has no relevance here.
76. (1994) 16 NZTC 11,303.
77. [1989] DCR 481.
78. [1996] 1 NZLR 310.
79. [1993] 2 CTC 243.
80. Although such expenditure would only be deductible to the extent that it satisfied section BB 7.
81. E.g. freight, custom or other transportation charges.
82. Arguably, this result "matches" the income, i.e. the sale proceeds received from the sale of the goods, with the expenditure, i.e. the reasonably estimated cost of meeting warranty claims. This analysis is consistent with views expressed in Butterworth's Australian Weekly Tax Bulletin (No 49) commentary on the decision (at page 793): "It is submitted that the additional requirement introduced by the High Court in *Coles Myer Finance Pty Ltd* v *FCT* (1993) 25 ATR 95, that a deduction must be claimed over the period to which it is properly referable, would not apply to warranty provisions. There are no goods or services provided to the company over a period of time as a result of the liability. That is, there is no relevant benefit from the liability which the company can put to profitable advantage."

83. Again, assuming such expenditure is deductible under section BB 7.
84. E.g. freight, custom or other transportation charges.
85. i.e. that the words "relates to" mean the provision may also apply to expenditure that is ancillary to, or in connection with, services provided to a person other than the taxpayer and for which the taxpayer does not pay.
86. (1994) 16 NZTC 6,190.
87. (1996) 17 NZTC 7,551.
88. In *Mitsubishi* warranties were given by the dealers to customers, rather than by MMNZ, through the dealers. Refer page 12,354 of the Privy Council decision.
89. In such circumstances it might be argued that the taxpayer providing the warranty has in fact provided a service to the dealer (rather than the other way around) by agreeing to reimburse the dealer for the repair costs incurred.
90. *Torkington* v *Magee* [1902] 2 KB 427, 430.
91. It is a generally recognised principle of statutory interpretation that a construction which would leave without effect any part of the language of a statute will normally be rejected refer: *Maxwell on the Interpretation of Statutes* (Sweet & Maxwell 1969) at page 36. For example, in *Re Svenska Aktiebolaget Gasaccumulator's Application* [1962] 1 All ER 886, 890–891 the English Court of Appeal had to consider the effect of section 34(1) of the Trade Marks Act 1938 which stated: "The registrar may, on request ...enter a disclaimer or memorandum relating to a trade mark which does not in any way extend the rights given by the existing registration of the trade mark". Lord Evershed MR disagreed with the lower court's limited interpretation of the words "memorandum relating to a trade mark". He considered that they imposed a deliberately wide formula and must fairly extend to memoranda sensibly related to any trade mark. He noted: "It seems indeed to us that if the judge be right, it is at least arguable that the words 'which does not in any way extend', etc are unnecessary." The Court held that the section should not be construed in such a way as to render those words otiose.
92. Glazebrook and Oliver in "The New Zealand Accrual Regime — a practical guide" *CCH* (1989) at page 196 point out that matching may not always result under section EF 1 (section 104A of the *Income Tax Act* 1976): "Therefore, although sec 104A means that there is greater conformity between the concept of the incurring of an expense for financial accounting purposes and the incurring of an expense for tax accounting purposes, sec 104A does not go so far as to require the financial accounting concept of matching for tax purposes."
93. An alternative to MMNZ's argument that the full warranty costs had been incurred and could be deducted. It is also similar to the result reached in the *Coles Myer* case where the Full High Court of Australia held that although the discount on bills of exchange represented a liability in the year of discount, the discount was required to be apportioned over the term of the relevant bill.
94. (1995) 17 NZTC 12,230. The taxpayer is appealing this decision.