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Meaning of “incurred” – the Privy Council decision in the Mitsubishi case

Inland Revenue
Te Tari Taake

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Summary

This interpretation statement considers the Privy Council decision *Commissioner of Inland Revenue v Mitsubishi Motors New Zealand Limited* (1995) 17 NZTC 12,351 ("*Mitsubishi*"). That case dealt with the timing of deductions and, in particular, the meaning of "incurred" (as it now appears in section BD 2(1)(b)) in the context of warranty expenditure. The Privy Council held that the taxpayer in the case incurred future estimated warranty expenditure in the year in which it sold the warranted vehicles and, as a consequence, was entitled to take a deduction for that estimated expenditure in that income year.

This statement sets out Inland Revenue's interpretation of the meaning of "incurred" in the light of *Mitsubishi*. It also considers:

- what is required in terms of a reasonable estimation of future estimated expenditure;
- how to account for estimated liabilities, including in the first year that an estimated basis is adopted; and
- the application of section EF 1.

In this regard, this statement reaches the following conclusions:

- The *Mitsubishi* decision applies to express warranties of the type considered in the case. It also applies to warranties and guarantees of a similar nature implied under statute. It is acknowledged that the decision has potentially widened the meaning of "incurred". In some situations this will mean that taxpayers are able to claim deductions in anticipation of expenditure, where previously a deduction could be claimed only after an obligation to pay a particular 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.
- In addition, to rely on *Mitsubishi* taxpayers must be 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 has not been incurred in that income year. The authorities 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. To this end, Inland Revenue will require taxpayers who seek to rely on the *Mitsubishi* decision to substantiate claims made on the basis of estimated future expenditure in the light of their particular circumstances.
- The approach taken in the insurance industry in relation to expenditure which has been "incurred but not reported" (IBNR) reporting is accepted as a workable treatment for accounting for estimated future expenditure for which deductions are available in accordance with *Mitsubishi*. In changing to such a method, it is acceptable to take a deduction in the first year of adjustment of all estimated future expenditure for which a deduction is available on the basis of the reasoning in *Mitsubishi*. In this regard, the Commissioner will exercise his discretion under section EC 1(1) and EC 1(3) to permit a deduction for all estimated future warranty claims in the first year, without requiring any corresponding adding back of the estimated claims as at the beginning of that year. In some cases it may be necessary to re-estimate (either upwards or downwards) estimated claims relating to previous income years. In both cases, the adjustment should be made in the year in which the revised estimate is made, and not in the original year of deduction.
- Inland Revenue accepts that section EF 1 does not apply to require the adding back of warranty expenditure in the same or similar factual situations to those which arose in *Mitsubishi*. It is considered to be unclear whether the words of section EF 1 are wide enough to apply to expenditure incurred by a warrantor in the same or similar circumstances to those which arose in the case. Given such ambiguity it is necessary to look to the legislative context and background to the enactment of the provision, as considered by the courts. Taking into account such matters, and in particular the recent Court of Appeal judgment in *Thornton Estates Ltd. v CIR* (1998) 18 NZTC 13,577, it is considered that the better view is that the section is aimed at achieving matching of the timing of deductions with the income flowing from that expenditure, and should be interpreted in a way that is consistent with that aim. To apply section EF 1 to facts analogous to those arising in *Mitsubishi* would result in a taxation treatment that differs from matching in those terms.

Background

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 their dealership 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.

The High Court found in favour of the taxpayer: *Mitsubishi Motors New Zealand Ltd v CIR* (1993) 15 NZTC 10,163. Doogue J held that the taxpayer was definitively committed to the warranty expenditure as at the time of sale and delivery of the vehicles.

The Court of Appeal also found for the taxpayer, but on a different basis: *CIR v Mitsubishi Motors New Zealand Ltd* (1994) 16 NZTC 11,099. 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.

The Commissioner appealed from that decision to the Privy Council. The Privy Council dismissed the Commissioner's appeal, finding for the taxpayer on the question of deductibility on the basis that the taxpayer was definitively committed to the future warranty expenditure.

Inland Revenue released an issues paper, *Implications of the Mitsubishi Decision* on 10 December 1996 (Issues Paper No 2: reference 3533) ("the issues paper"). The submissions received in response to that paper have been fully considered in the formulation of this interpretation statement.

In December 1997 the Court of Appeal heard the case of *Thornton Estates Ltd. v CIR*. That decision is discussed below in relation to the issue of the application of section EF 1 to the deductibility of warranty expenditure.

Legislation

Section BD 2(1) determines what is meant by an allowable deduction. It states:

An amount is an allowable deduction of a taxpayer

…

(b) to the extent that it is an expenditure or loss

- (i) **incurred** by the taxpayer in deriving the taxpayer's gross income, or
- (ii) necessarily **incurred** by the taxpayer in the course of carrying on a business for the purpose of deriving the taxpayer's gross income, or
- (iii) allowed as a deduction to the taxpayer under Part C (Income Further Defined), D (Deductions Further Defined), E (Timing of Income and Deductions), F (Apportionment and Recharacterised Transactions), G (Avoidance and Non-Market Transactions), H (Treatment of Net Income of Certain Entities), I (Treatment of Net Losses), L (Credits) or M (Tax Payments). (*Emphasis added*)

Section BD 4 allocates allowable deductions to particular income years. It states:

(1) A taxpayer or the Commissioner must allocate each allowable deduction to an income year in accordance with this section.

(2) If an allowable deduction is subject to a timing regime, the deduction must be allocated to an income year in accordance with that regime.

(3) An allowable deduction that is not subject to a timing regime must be allocated to the income year in which the allowable deduction is **incurred**.

(4) If an expenditure or loss gives rise to more than one allowable deduction, the allowable deductions may be allocated to income years to the extent that their total does not exceed the amount of that expenditure or loss. (*Emphasis added*)

Section EC 1 provides a mechanism by which the Commissioner may make adjustments in one income year for incorrect accounting practice in previous years. It states:

(1) This section applies if in respect of an income year (that income year being referred to in this section as the "year of adjustment") the Commissioner is satisfied that the gross income or allowable deductions of a person in respect of a business for any income year or income years (that income year or those income years being referred to in this section as the "preceding period") preceding the year of adjustment have been understated or overstated by reason of the whole or any part of that gross income or those allowable deductions having been calculated -

- (a) By reference to cash receipts or outgoings and without taking into account amounts owing to or by the taxpayer at the beginning or end of any income year in the preceding period; or
- (b) By taking into account provisions or reserves which are not allowed as deductions; or
- (c) Without taking into account provisions or reserves which are allowed as deductions; or

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(d) By including as gross income for an income year in the preceding period an incorrect proportion of any amount received by the taxpayer in respect of transactions not completed at the end of the income year.

(2) The Commissioner may, with respect to a taxpayer to whom this section applies and to a year of adjustment, deem the following amounts to be gross income derived by the taxpayer in that year -

(a) Where subsection (1)(a) applies, the total of the amounts owing to the taxpayer at the end of the preceding period; and

(b) The total amount of any provisions or reserves to which subsection (1)(b) refers; and

(c) The total of any amounts to which paragraph (d) refers that are in respect of transactions not completed at the end of the preceding period and that had not been included in annual gross income for any income year in the preceding period.

(3) The Commissioner may, with respect to a taxpayer to whom this section applies and to a year of adjustment, deem the following amounts to be allowable deductions incurred by the taxpayer in that year -

(a) Where subsection (1)(a) applies, the total of the amounts owed by the taxpayer at the end of the preceding period; and

(b) The total amount of any provisions or reserves to which subsection (1)(c) refers; and

(c) The total of any amounts to which subsection (1)(d) refers that are in respect of transactions not completed at the end of the preceding period and that had been incorrectly included in annual gross income for any income year in the preceding period.

…

Section EF 1 deals with “accrual expenditure”. It provides 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. It states:

(1) Where any person has incurred any accrual expenditure -

(a) That expenditure is allowed as a deduction when it is incurred in accordance with this Act; and

(b) The unexpired portion of that expenditure at the end of an income year shall be included in the gross income of the person for that income year and shall be allowed as a deduction in the following income year.

(2) (*repealed*)

…

(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 expenditure incurred on goods not used in deriving gross 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 is enforceable.

(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.

…

(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.

…

“Accrual expenditure” is defined in section OB 1:

“**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:

Privy Council decision

Facts

As indicated in the "Background" section, the case involved the timing of the deductibility of warranty expenditure. The taxpayer assembled new motor vehicles and sold them under warranty through franchised dealers. The warranty provided against defects appearing in the material or workmanship of the vehicle during the warranty period. The issue before the courts was whether, in computing its profits or gains, the taxpayer could deduct its anticipated liabilities under warranties which remained unexpired at the end of the income year, for vehicles sold during that income year.

Decision

The Privy Council dismissed the Commissioner's appeal, finding for the taxpayer on the question of deductibility on the basis that the taxpayer was definitively committed to the future warranty expenditure.

The Privy Council was satisfied that the evidence showed that it was in accordance with proper accounting treatment for the taxpayer 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. Their Lordships noted that the evidence before the High Court satisfied Doogue J that a reasonable estimation could be placed upon the anticipated liabilities.

The Privy Council considered that the New Zealand courts have "followed Australian authorities" on the meaning of "incurred". "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, their Lordships referred to 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.

The Privy Council made two specific observations about the test. First, that the test focuses on *particular* items of expenditure. Their Lordships 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.

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 was noted that "on one view" this requires, as a matter of construction, deciding whether the obligation is "contingent", or, alternatively, "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.

The Privy Council considered that these two specific features of the meaning of "incurred" 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. In their Lordships' view this was illustrated to some extent by the Australian decisions in this area.

The Privy Council considered that the "incurred" test is *primarily* one of construction. It was therefore necessary to consider the words of the warranty. The warranty provided:

1. 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.
2. This warranty shall not apply if the vehicle has been repaired or altered in any way other than by the vendor or in any service workshop not authorised by the vendor, or if the vehicle has been subjected to misuse neglect or accident, or if it has been loaded beyond manufacturer's loading capacity or operated in such a way that is not recommended by the manufacturer.
3. The vendor shall not be liable for any loss or any consequential loss damage or expenses arising directly or indirectly from the defect.
4. This warranty is in lieu of all warranties terms conditions representations expressed or implied whether by common law or statute.
5. The new vehicle warranty period shall be 12 calendar months after delivery of the vehicle to the original purchaser or until the vehicle shall have run 20,000 km whichever first occurs.

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However, their Lordships then went on to say that in their view the form of the warranty was not the final consideration. It was also necessary to look to two other principles, i.e.:

- the fact that the jurisprudential approach to the meaning of "incurred" does not rule out statistical estimation of facts which have happened, but are not yet known to the taxpayer. (The Privy Council saw this as being distinct from treating an aggregate of contingent liabilities as a statistical certainty, which their Lordships 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.

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* (1974) 4 ATR 610. In that case, an insurance company was allowed to make a deduction from its premiums of an estimated sum to represent its IBNR liabilities. 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. Applying the approach taken in the insurance cases to the facts in *Mitsubishi*, the Privy Council then concluded (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.

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 were 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 were 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.

Although, the Privy Council reconfirmed the Court of Appeal's analysis of the warranty, i.e. that it requires manifestation and notification to trigger liability, the Privy Council considered that the Australian cases dealing with the meaning of incurred 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". Their Lordships restated this aspect of the test in the following terms (at page 12,355):

> …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.

The Privy Council considered whether there was a contingent, or merely a theoretical, liability in the case of warranty claims in relation to vehicles sold by the taxpayer, 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 considered 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 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.

On the basis of this analysis the Privy Council held that the estimated warranty costs were deductible at the time of sale.

Conclusions

It is possible to draw the following conclusions from the Privy Council's analysis and application of the meaning of "incurred":

- Where the expenditure arises under an 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 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.

Application

The meaning of "incurred" following the decision

The *Mitsubishi* decision provides 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.

In evaluating how *Mitsubishi* restates the meaning of "incurred", it is useful to "measure" the decision against the four propositions laid down in *Bisley* (referred to by the Privy Council and set out above):

- *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;*

The *Mitsubishi* decision suggests 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 the 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" (now in section BD 2(1)(b)) had been interpreted as referring to particular items of expenditure "rather than the aggregate sums which would concern a businessman drawing up his accounts". In their Lordships' view 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 in the case. This is because the case was not concerned with the deductibility of specific liabilities as at year-end. However, 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.

- *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. On one interpretation, the decision has replaced the "contingent, versus vested, but defeasible" dichotomy with a new test as to "defeasibility", i.e. *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 in some cases to look beyond any legally binding arrangements which are pertinent to the creation of the liability, e.g. notice requirements.

Warranties

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

The decision will generally also apply to other manufacturing, distributing, wholesaling, and retailing taxpayers who provide warranties to remedy inherent defects in new 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.

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 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. Given this standard, the amount deducted for tax purposes may vary from the reserve adopted for financial accounting purposes.

Free servicing

Many taxpayers who offer warranties to customers for new goods sold also offer free servicing for a defined

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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.

It is generally accepted that 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. Inland Revenue accepts that 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.

However, a deduction at the time of sale will only be available if the taxpayer is able to substantiate the amount sought with reference to accurate 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.)

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 usually 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.

Sometimes the distinction between warranties, free servicing arrangements, and service contracts may be difficult to discern. 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.

Implied warranties

Inland Revenue accepts 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, it is accepted that the reasoning in the *Mitsubishi* decision will generally apply.

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.

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. 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 sales records. 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.

Fair Trading Act 1986

In this context a further issue arises as to whether similar principles might apply to obligations imposed under the Fair Trading Act 1986.

Broadly, the Fair Trading Act prohibits misleading and deceptive conduct by suppliers of goods and services to consumers. For example, it prohibits the making of false representations in relation to the supply of goods and services, and prohibits a range of specific practices, e.g. offering goods and services where there is no intention of supplying them, pyramid selling schemes, importing goods bearing false trade descriptions or trade marks. The Act also provides for the prescribing of consumer information standards requiring disclosure of information relating to such matters as the kind, grade, quantity, origin, performance, care, use, etc., of goods and services.

Generally speaking, contravening any of the provisions of the Act is an offence and gives rise to either civil liability alone (most notably in the case of misleading or deceptive conduct), or both civil and criminal liability. The Act extends rights to the public to take action against suppliers or manufacturers. A court is empowered to make a range of orders in such cases, including ordering compensation or the refunding of money.

In this way, the focus of the Fair Trading Act is essentially on the prevention of wilful acts of deception.

Although on one level it might be possible to say that a supplier or manufacturer from time to time supplies goods or services which are inherently in contravention of the Act, it would seem somewhat unusual for a supplier or manufacturer to be in a position where its past conduct was such that it could reliably estimate what its future liability would be from year to year. This seems contrary to the aim of the fair trading legislation which is to deter future offending by imposing penalties. It also ignores the fact that it would presumably be very difficult to estimate the level of claim, even if the frequency of offending could be reliably estimated.

Therefore, intrinsically, obligations arising under the Fair Trading Act do not seem to be analogous to obligations arising under warranties against inherent defects, whether contractual or implied. In the case of a warranty against inherent defects, the underlying rationale is that the manufacturer or supplier strives to sell a defect-free product, rather than deliberately or recklessly selling defective items subject to a warranty.

In summary, subject in every case to being able to make a reasonable estimation of future liabilities, Inland Revenue accepts that 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, may rely on *Mitsubishi*. However, the reasoning in *Mitsubishi* will not apply to obligations imposed under the Fair Trading Act.

Service providers

A further issue in this context is whether 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 provided, 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.

Inland Revenue acknowledges that there may be situations where the reasoning in *Mitsubishi* applies to service providers. However, the arguments for applying the reasoning in those instances are considered to be 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 or "defective" 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.

In addition, when compared with the facts in *Mitsubishi*, it is considered that 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 would seem 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 considered to be more likely that in the services arena taxpayers will 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. Given this, it is considered 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 "provision", suitable for financial accounting purposes, and a quantifiable deduction for tax purposes.

Although, it is acknowledged that in very limited situations it may be possible to make a reasonable estimation of future liability in relation to the repeated provision of certain, discrete services, in general the Commissioner considers that the reasoning in *Mitsubishi* will not apply to taxpayers who provide services. However, if taxpayers who provide services are in doubt in relation to their particular circumstances, they may approach their local Inland Revenue office for guidance.

Wider implications

Inland Revenue acknowledges 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).

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. It is considered that the Privy Council decision raises further difficulties in terms of applying it to new fact situations because:

- although the Privy Council recognised that the test for deductibility in section BD 2(1)(b) is concerned with *particular* items of expenditure, rather than deductions for aggregate sums (at page 12,353), their Lordships went on to reach their 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 Assurance Co of Australia Limited v FCT* (1977) 7 ATR 435). However, in

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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 the insurance under consideration, 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, the taxpayer 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. Had the warranty period been for longer, e.g. 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. It should be noted, however, that longer warranty periods may also raise questions as to whether future liability can be attributed to defects which were present at the time of sale.

- 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 discount 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, it is considered that such an 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 may be arguable that there is no existing obligation - the liability is still a contingent one.

In addition, Inland Revenue considers that in applying the meaning of "incurred" in the future, taxpayers should bear 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. For example, in such cases it will still be relevant to ask whether the particular expenditure is no more than "impending, threatened or expected": *New Zealand Flax Investments Ltd. v FC of T* (1938) 5 ATD 36, 49.

Conclusions

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

Inland Revenue acknowledges that the decision has potentially widened the application of the meaning of "incurred". 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 a particular 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.

Reasonable estimation

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

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. 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. Nor, was there any discussion of this issue in the High Court or Court of Appeal judgments.

The issue of what constitutes a reasonable estimate of expenditure or loss under section BD 2(1)(b) has had very little consideration by the New Zealand courts. However, the Australian courts have considered the question relatively recently. In *ANZ Banking Group Limited v Federal Commissioner of Taxation* (1994) 27 ATR 559, 571-573, the Full Federal Court of Australia, 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* [1912] AC 443, 454).
- 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 necessarily mean it is unreasonable.

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 the basis of probabilities.

The *ANZ Banking* case supports a rigorous approach to the application of *Mitsubishi* to estimations provided by taxpayers. Although it is difficult to set general guidelines for what is required by individual taxpayers in terms of providing reasonable estimates, in broad terms, at a minimum, Inland Revenue will require taxpayers 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 be necessary for taxpayers to justify their methods of calculation in the light of their particular circumstances and to continually reassess the method of estimation adopted in the light of changing circumstances.

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 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. Nor, would it generally be acceptable for taxpayers to base deductions on some kind of "industry standard", unless it could be shown that those standards apply to the taxpayer's specific circumstances. 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 provision. This may be appropriate for financial accounting purposes, but will generally not be a reasonable estimate for tax purposes. If taxpayers are unsure as to what is required in their particular situation, then they may approach their local Inland Revenue office for further guidance.

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

- no past history of claims (e.g. in the first year of operation);
- 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.

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.

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 increase (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 (e.g. *Burrill v FCT* 96 ATC 4,629).

Standard of estimation

It is acknowledged that the previous analysis imposes a high standard. A contrary view is that there is authority to support a "reasonable attempt" or "conservative estimate" as being sufficient and that smaller taxpayers should not be disadvantaged (in comparison with larger corporate taxpayers) solely because they do not maintain sophisticated systems, or have detailed information. For example, it might be argued that the essence of Lord Loreburn's judgment in the *Sun Insurance Office* decision is that where an estimate is required, then the method that "comes nearer to the truth" than any other method should be accepted (rather than no estimate at all being taken). On such a basis, it should be possible for smaller taxpayers to make a provision based on a conservative (from a tax perspective) estimate and, as a result would resolve issues concerning the level of information required and the consequences of changes in product lines.

What standard of evidence is required? It is considered that the common thread throughout the case law in this area is that an estimate must be reasonable and reliable, and what is reasonable and reliable in any particular case will necessarily depend on the facts of that case. For example, in *Sun Insurance* itself the taxpayer, a fire insurer, carried to reserve each year a sum equal to 40% of the year's premium income. It was estimated that this was the amount necessary to meet unexpired risks. The House of Lords held that this was a reasonable and proper allowance, given that in assessing a fire insurance company it was necessary to proceed by estimate. Lord

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Loreburn accepted the taxpayer's method as being the only way in which the true gains of the company could be ascertained, but noted that this result was not of universal application (at page 77):

> …there is no rule of law as to the proper way of making an estimate. There is no way of estimating, which is right or wrong in itself. It is a question of fact and figure whether the way of making the estimate in any case is the best way for that case.

Similar sentiments were expressed in *ANZ Banking*, where Hill J noted (at page 571) that:

> The concept of "estimate" does not involve arbitrarily seizing upon any figure. What is involved is the formation of a judgment or opinion based upon reason. That judgment or opinion must necessarily be made bona fide but it need not be exact for the process of estimation involves a process of approximation.

Applying those principles to the facts of that case, Hill J concluded (at page 573):

> In my view the present is not a case where it can be said that there can be no process of estimation or that no process of estimation was in fact made because the figure adopted was not reasonably arrived at. Rather, the establishment of provisions in the present case was an exercise capable of approximate calculation based on probabilities.

On this basis, Inland Revenue does not accept that any "guess" will do, or that a small, conservative (in tax terms) deduction, taken on the basis that the future liability is bound to exceed that amount, is permissible. The cases tend to indicate that there must be some method advanced to support the deduction taken, and that method must be based on past experience – the deduction sought thereby being "capable" of estimation.

Estimation as part of the "incurred" test

It has been suggested that the question of whether an expense has been incurred, and the quantification of that expense, are completely separate issues, i.e. the requirement to make a reasonable estimate is not part of the "incurred" test. The fact that expenditure is incurred means that the taxpayer may (and in fact is required to) make the best possible estimate based on the information available, even if there is a paucity of such information.

However, this approach is not consistent with the reasoning of the Privy Council in *Mitsubishi*. At page 12,355 of the decision, having agreed with the Court of Appeal's analysis of the warranty provision, i.e. as being one that gave rise to a liability contingent on a defect appearing and being notified within the warranty period, Lord Hoffman went on to state that this was not the end of the matter because of two further principles that must be taken into account; the first being:

> …that although the jurisprudential approach prevents one from treating an aggregate of contingent liabilities as a statistical certainty**, it does not rule out statistical estimation of facts which have happened but are unknown**..
>
> 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 kms.
>
> …
>
> This, however, is not in itself enough to show that a liability was incurred. …(*Emphasis added*)

The Privy Council felt able to circumvent the problem of an aggregate of contingent liabilities *because* of the taxpayer's ability to make an estimation of that collective liability. Although, the judgment does not address how reliable that evidence needs to be, their Lordships' reasoning makes it clear that the requirement that there be a reasonable estimate is intrinsic to the application of the "incurred" test in similar fact situations. It is not a separate consideration, but rather a fundamental aspect of the test, i.e. without the ability to make a reasonable estimate the liability has not been incurred.

This approach is not new. For example, the decision in *Texas Co (Australia) Ltd v FCT* (1940) 63 CLR 382 has always stood for the principle that a taxpayer may completely subject itself to a liability notwithstanding that the quantum of that liability cannot be precisely ascertained, *provided that* it is capable of reasonable estimation. A similar approach was taken in the *ANZ Banking Group* decision discussed above and confirmed by Hill J in *Ogilvy & Mather Pty Ltd v FC of T* (1990) ATR 841, 874.

The question is how much can actually be said to have been incurred, not how low should the amount taken as a deduction be to ensure that it will not ultimately be exceeded. Section BD 4 refers to the allocation of allowable deductions to the income year in which the deduction has been *incurred* – this is the only legal basis on which a deduction may be taken in a particular income year. It follows that determining how much should be deducted in any year must form part of the "incurred" test.

In addition, the suggestion that estimation does not form part of that test does not address the situation where the taxpayer is unable to make any kind of estimate (e.g. in some cases in the first year of operation). If the requirement to be able to reasonably estimate is interpreted as not being part of the "incurred" test, then no deduction is available at all in that year, or subsequently, due to the ability to deduct being linked to the year of incurrence. It is considered that this result also suggests that the ability to estimate reasonably is part of, rather than an adjunct to, the "incurred" test.

Conclusions

In order 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.

The standard of calculation demonstrated by the taxpayer in *Mitsubishi*, 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. To that end, Inland Revenue will require taxpayers to substantiate claims made on the basis of estimated future expenditure in the light of their particular circumstances. If taxpayers are unsure as to what is required in their particular situation, then they may approach Inland Revenue for further guidance.

Accounting for estimated liabilities

Mitsubishi permits taxpayers to make deductions in the year of sale for estimated warranty costs. In most instances such estimates will prove to be incorrect in following years, when compared with actual expenditure. The original deduction will prove to be either 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.

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: *RACV Insurance* at pages 618 and 627. However, this 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.

IBNR approach

As seen above, the Privy Council decision refers to the taxation treatment of the general insurance industry; in particular, the judicial acceptance that reasonably estimated provisions for "incurred but not reported" (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 *RACV Insurance* and more explicitly in the *Commercial Union* decision.

The treatment was summarised by Newton J in *Commercial Union* (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*)

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*)

Newton J noted (at page 445) 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, treating any increase as an allowable deduction for that second year and any decrease as part of the assessable income of that year.

Further support for this approach is found in the Privy Council decision *Southern Pacific Insurance Co (Fiji) Ltd v IRC (Fiji)* [1986] STC 178. 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.

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.

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This treatment has also been endorsed by the Australian Taxation Office in IT 2663 *Income Tax: Basis of Assessment of General Insurance Activities* (20 December 1991) at paragraphs 136 to 139. The ruling provides for a general insurer to compare 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; 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 approach.

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 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. It is acknowledged that this may lead to an unworkable position from a compliance perspective.

Adoption of an IBNR approach

Inland Revenue considers that the approach taken in the insurance industry in relation to IBNR reporting provides a workable treatment for dealing with adjustments in the context of estimated warranty costs. This approach has been upheld by the courts in the context of general insurance taxpayers and applied for many years. Although there may be difficulties with explicitly justifying an IBNR 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), it is considered that in the absence of express legislation dealing with estimated but incurred expenditure, such an approach produces the best and most workable solution to the question of adjustments. It is therefore proposed to apply an IBNR approach to estimated warranty costs for which deductions are available in accordance with *Mitsubishi*.

First year of deduction

The adoption of an IBNR approach to estimated future expenditure raises the question of how the first year of estimated deductions should be handled. This is essentially an issue concerning changes in accounting treatment, similar to those raised in cases such as *Henderson v FCT* (1970) 119 CLR 612 and *Country Magazine Pty Limited v FCT* (1968) 15 ATD 86; (1968) 42 ALJR 42.

The issue in this context is whether it is possible to take a deduction in the first year for all estimated future expenditure outstanding at year-end, whether it relates to events giving rise to liability occurring in that income year, or past income years. The alternative would be to restrict the deduction to only estimated future expenditure arising out of events that occurred in that income year, on the basis that it is only that expenditure which has been *incurred* in that year. This would be achieved by requiring taxpayers to make a notional opening balance adjustment in the first year – effectively adding back estimated claims as at the beginning of that year.

It is considered that from a purely technical perspective there is a strong case for requiring an opening balance adjustment to be made. This particularly flows from a close analysis of the *Commercial Union* decision. In that case it was held that the taxpayer, an insurance company, could take a deduction for provisions made for IBNR claims, even though it was a condition precedent of the relevant insurance policies that insured persons make their claims within a certain period. The Court held that there was in effect strict liability and, therefore, the taxpayer became definitively committed to the liability upon the happening of the insured event.

The case also concerned the issue of how IBNR provisions should be accounted for. Prior to the year ended 30 June 1973 the taxpayer had only taken deductions for outstanding and reported claims, although it was acknowledged that those estimates had been uplifted by 5% to 10% each year to take into account IBNR claims. During the 1973 income year it became apparent that this method of providing for IBNRs was unsatisfactory, and from that year on it was decided to estimate the IBNR claims separately.

As regards the way in which the IBNR claims had been accounted for, the Commissioner argued that:

- even if the IBNRs were deductible in principle, the company had not adopted a consistent basis of estimating IBNRs at the end of the income year and the preceding income year; and
- because the taxpayer's IBNR estimates included amounts in respect of unreported insured events that had occurred in prior years, those amounts should be excluded from the allowable deductions for the year in question since they would have been incurred in previous years.

Newton J rejected both arguments. As discussed above, as regards the first argument his Honour confirmed that the IBNR approach, although perhaps technically incorrect, was acceptable given that it gave the right result. He then went on to directly consider the issue of whether or not a notional amount should be added back in the "first" (1973) year (at page 446):

> It was contended in substance on behalf of the Commissioner that if in fact the provision of $5,864,866 in respect of claims incurred but not reported as at 30 June 1973, was an allowable deduction in calculating the taxable income of the Commercial Union Pool for the year ended 30 June 1973, as part of the total deduction of $60,020,125 for all outstanding claims as at 30 June 1973, then for the purpose of calculating the taxable income of the Pool for the year ended 30 June 1973, **an appropriate amount in respect of claims incurred but not**

reported as at 30 June 1972, should be added to the sum of $39,559,704 which, as earlier stated, had been included in the assessable income of the Pool for the year ended 30 June 1973, as representing the provision for outstanding claims as at 30 June 1972 If this were done, then of course the allowance of the sum of $5,864,866 as a deduction would be offset by a substantial amount... (*Emphasis added*)

Newton J rejected this contention. His Honour noted that if it were correct then in his view no deduction would ever be allowed in respect of IBNR claims as at 30 June 1972 in calculating the taxable income of the taxpayer for any year, not even when the claims were paid.

The reasons for this conclusion are interesting – Newton J considered that there was no material difference between the character of the provision for all claims as at 30 June 1973 and as at 30 June 1972. This was despite the fact that the later year included a separate IBNR amount. His Honour considered that both sums were a "total provision" for outstanding claims as at the end of the income year. In addition, the 1972 provision included an amount for IBNR claims, although not separately calculated. On this basis, Newton J concluded that there was *no change in accounting methods* – "there was merely a refinement in the method of calculation or estimation of the component of the provision for outstanding claims at the end of the year, which was intended to represent claims incurred but not reported".

He then expressly noted (at page 447) that on this basis it was unnecessary for him to consider what would be the position if there had been a material difference in the character of the provisions so that there was a relevant change in accounting methods.

Newton J also rejected the Commissioner's second argument, i.e. the contention that on no view could a provision for IBNR claims, where the event insured against had occurred before 1 July 1972, be an allowable deduction in calculating the taxpayer's income for the year ended 30 June 1973. His Honour considered that in so far as the IBNR figure as at 30 June 1973 represented any claims arising out of events occurring in previous years, this simply represented a *re-estimate* of the taxpayer's liability in respect of those claims. He considered that the words "assessable income" in section 51(1) of the Income Tax Assessment Act 1936 meant assessable income of the taxpayer generally without regard to division into annual accounting periods and therefore, just as it is possible to take an IBNR deduction for claims arising out of events in the relevant year, it is possible to take a deduction for an increase in an estimate at the end of that year for any claims arising out of previous years which are then still outstanding.

In this way, Newton J treated the 1973 IBNR amount as being simply a re-estimate of the earlier IBNR deductions which formed an unspecified part of the outstanding reported claims for those previous years.

Therefore, although on the facts of the case Newton J decided that there was no need to add back a notional opening amount, this essentially turned on the fact that in prior years there had been some kind of deduction made for IBNR claims – meaning that there was no movement to a new accounting method, and the first year in which a separate IBNR deduction was taken simply represented a re-estimate of IBNR claims relating to previous years.

In response to the *Commercial Union* decision the ATO released ruling IT 110 *General Insurance Companies: Claims Incurred But Not Reported* (28 October 1977). The ruling set out the "advice" that was sent to branch offices in the light of the decision. The ruling adopts the view that the conclusion that the company's method of calculation of outstanding claims in the first year that IBNRs were separately claimed was merely a refinement of earlier methods was a reasonable one in the circumstances. However, the conclusion reached on the second issue discussed above, i.e. whether it is possible to take an IBNR deduction in one year in respect of unreported insured events that had occurred in prior years, is considered by the ATO to be "more doubtful". IT 110 notes:

However, that issue is of relatively minor importance once the basic principle of the deductibility of IBNRs is accepted and the Judge's approach to it is a logical and reasonable one, at least from a practical viewpoint.

The ruling goes on to conclude that where IBNRs are claimed as a separate item for the first time in a year of income, because it is probable that an over-estimate of outstanding reported claims has occurred (as was the situation in the case) or because the IBNRs are really no different in character to those claims (Newton J's second argument), then:

It will not be necessary in these cases, therefore, where a company has claimed IBNRs as a separate item for the first time in a particular year of income, to reduce the deduction claimed by some amount which ought to have been claimed as IBNRs in the immediately proceeding year (except in the extremely unlikely event that an insurance company has operated for a number of years without ever claiming deductions for outstanding claims of any kind).

Therefore, although Newton J decided on the facts before him that it was not necessary for the taxpayer to add back any notional amount to relate to IBNRs for previous income years, this seems to be based on factors that would not be present in the case of taxpayers seeking to rely on the *Mitsubishi* decision. It is more likely that such a taxpayer would be moving to a new accounting treatment whereby it would be taking a deduction for estimated expenditure, as opposed to actual expenditure, for the first time. On a strict application it follows that this change in accounting treatment should result in only deductions for future estimated expenditure relating to that income year being taken. This is achieved by requiring an "add-back" of the notional amount of estimated future expenditure at the beginning of the first year so that 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, is deductible.

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Section EC 1

Section EC 1(1) applies if in relation to any income year (the year of adjustment) the Commissioner is satisfied that the allowable deductions of a person, in respect of a business for any preceding income year or years, have been understated by reason of those deductions having been calculated without taking into account provisions or reserves which are allowed as deductions. Under section EC 1(3), the Commissioner may deem the amount of such provisions or reserves as allowable deductions incurred by the taxpayer in the year of adjustment.

Section EC 1 was first enacted as section 92A of the Land and Income Tax Act 1954. It was a response to the decision in *Henderson* where it was held that if a taxpayer moved from a cash basis to an earnings basis of accounting for income, it was correct not to account for income earned in the cash basis years, even though it was paid to the taxpayer in subsequent years. Section EC 1 was, therefore, primarily designed to enable the Commissioner to include within assessable income any income that might otherwise escape taxation as a result of a change in a taxpayer's method of tax accounting. However, the wording is clearly wider because, in addition, it gives the Commissioner a discretion to make an adjustment in a taxpayer's favour where he considers that there has been an understatement of income through failure to take into account allowable deductions which have been treated as provisions or reserves.

What constitutes a provision or reserve was considered by the Court of Appeal in *CIR v The Farmers' Trading Company Limited* (1989) 11 NZTC 6,007. In that case the Commissioner had attempted to apply the precursor to section EC 1 in order to bring to account proceeds from certain credit sales made in earlier years which the taxpayer had not brought to account due to having adopted a "profits emerging" accounting basis. The Court held (applying the decision in *CIR v National Bank of New Zealand Limited* (1976) 2 NZTC 61,150) that the equivalent to section EC 1(1)(b) had no application to a situation where the taxpayer had omitted income altogether, rather than brought income in from which an unauthorised deduction for a provision or reserve had been made. Richardson J (as he then was), who delivered the judgment of the Court, considered (at page 6,010) that as no guidance is given in the Act as to the meaning of the phrase "provisions or reserves" it was appropriate to look to generally accepted accounting principles and ordinary commercial practice in determining its meaning. In that regard, he referred to the definitions of the terms given in paragraph 2(1) of the Eighth Schedule to the Companies Act 1955 which provides:

For the purposes of this Schedule, unless the context otherwise requires, -

(a) The expression "provision" shall, subject to subclause (2) of this paragraph, mean any amount written off or retained by way of providing for depreciation, renewals, or diminution in value of assets or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy:

(b) The expression "reserve" shall not, subject as aforesaid, include any amount written off or retained by way of providing for depreciation, renewals, or diminution in value of assets or retained by way of providing for any known liability:

He also commented (at page 6,011) that in general terms a provision reflects a charge against profits, whereas a reserve reflects an allocation, or setting aside, of profits for future use or advantage.

It is considered that this definition of "provisions or reserves" is broad enough to encompass a situation where a taxpayer has brought to account income from the sale of warranted goods, and for financial reporting purposes, but not for tax purposes, has created a provision for the cost of meeting estimated future warranty claims. This would appear to be an amount retained (or charged against profits) by way of "providing for a known liability of which the amount cannot be determined with substantial accuracy".

Notwithstanding that a strong case can be made for the need to make an opening balance adjustment in the first year that a taxpayer changes to an estimated basis from an actual basis for accounting for warranty expenditure, it is acknowledged that this may lead to an unworkable position. Given this, and the scope of section EC 1, the Commissioner is prepared to exercise his discretion under that provision to permit a deduction for all estimated future warranty claims in the first year, without requiring any corresponding adding back of the estimated claims as at the beginning of that year.

Re-estimation

Another feature of the treatment of insurance claims is the recognition by the courts that in some cases it may be necessary 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. The need to re-estimate reflects the fact that at all times the deduction taken should reflect a "reasonable estimate" of the quantum of the underlying liability.

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. It is acknowledged that in such instances it may well be prudent from an accounting/commercial perspective to re-estimate the anticipated cost of meeting outstanding warranties.

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: *RACV Insurance* at pages 610 and 618; *Commercial Union* at pages 435 and 448, and the NZSA Financial Reporting Standard No. 7 (1994): Standard 5, at paragraphs 5.21 and 5.22.

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: *Commonwealth Aluminium Corp Ltd v FCT* (1977) 7 ATR 376, 386 and *International Nickel Australia Limited v FCT* (1977) 7 ATR 739; 743, 751 and 755.

It should also 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 considered that taxpayers must at all times satisfy a rigorous standard as regards their methods of calculating estimated liabilities. If Inland Revenue finds that taxpayers have not adopted, or have not continued to adopt, such a standard, it may not be possible to rely on the reasoning in *Mitsubishi* in relation to the timing of expenditure deductions.

Conclusions

Inland Revenue accepts that the approach taken in the insurance industry in relation to IBNR reporting provides a workable treatment for accounting for estimated future expenditure for which deductions are available in accordance with *Mitsubishi*. It has been used and accepted for a long time in the context of general insurance taxpayers and IBNR reserves, and in that context has received judicial support.

In changing to such a method it is acceptable to take a deduction in the first year of adjustment of all estimated future expenditure for which a deduction is available on the basis of the reasoning in *Mitsubishi*. The Commissioner is prepared to exercise his discretion under sections EC 1(1) and EC 1(3) to permit a deduction for all estimated future warranty claims in the first year, without requiring any corresponding adding back of the estimated claims as at the beginning of that year.

In some cases it may be necessary to re-estimate estimated claims relating to previous income years. This may involve, in the light of new information, *increasing* the quantum of those claims, and thereby taking a further deduction or, conversely, returning additional income in the event that revised estimates *reduce* the quantum of the estimated liability made in previous years. In both cases, the adjustment should be made in the year in which the revised estimate is made, and not in the original year of deduction. The need to re-estimate simply reflects the fact that at all times the deduction taken should reflect a "reasonable estimate" of the quantum of the underlying liability. In cases where taxpayers have not adopted, or have not continued to adopt, such a standard of estimation, it may not be possible to rely on the reasoning in *Mitsubishi* in relation to the timing of expenditure deductions.

Section EF 1

Section EF 1 is a "qualification" to the general position under the Act that expenditure relating to the derivation of gross income is deductible when incurred. Although a deduction is allowed for the expenditure incurred, under section EF 1 gross income is deemed to include the amount of the unexpired portion of any "accrual expenditure" that relates to future income years. In this way, section EF 1 modifies the section BD 2(1)(b) "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.

Under section EF 1(1), 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 gross income. 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 (which is not relevant here), or a chose in action. 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 it is cancelled.

Section EF 1 was not argued before the courts in *Mitsubishi*. However, it has been suggested that section EF 1 may apply to the facts of the case. That is to say, although the Privy Council established that the estimated warranty costs were deductible under the equivalent of section BD 2(1)(b), that deduction, or a part of it, may still have to be added back under section EF 1. This would have the practical effect of largely reversing the timing advantage that *Mitsubishi* affords taxpayers who are able to rely on the decision.

What follows is an analysis of the words of the section (and the issues raised in that regard), the legislative background to section EF 1 and a discussion of the *Thornton Estates* Court of Appeal decision.

Preliminary issue – is section EF 1 limited to pre-paid expenditure?

It is understood that section EF 1 is commonly seen as only applying to "pre-*paid* expenditure", i.e. taxpayers are required to add back the cost of goods, services or chooses in action actually paid for in advance of those items being applied to the production of assessable income. In this regard it has been suggested that sections EF 1(5)(b) and 1(5)(d) were never intended to apply to future payments, i.e. they were only aimed at pre-payment situations. It is argued that this approach is consistent with the legislative intent at the time of enactment, notwithstanding the subsequent introduction of section EF 1(5)(c) which clearly applies more widely. It has been observed that in the warranty context this

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approach has the attraction of eliminating the problems of applying those subsections – the taxpayer will not have made a payment for any goods or services, or for, or in relation to, any chose in action.

Although it is acknowledged that such an interpretation may resolve some of the uncertainty arising from the potential application of section EF 1 to warranty expenditure, it is considered that this approach is doubtful both in terms of the wording of the provision and the background to its introduction.

Section EF 1 applies to all accrual expenditure. "Accrual expenditure" is defined as being "any amount of expenditure *incurred* on or after 1 August 1986 by the person that is allowed a deduction under this Act ... other than expenditure *incurred*...". Under section EF 1(1), if any person has incurred any accrual expenditure, that person is allowed to take a deduction when it is incurred, but the unexpired portion of that expenditure at the end of an income year must be included as gross income. There is nothing in those words to suggest that the provision only applies to expenditure that has been incurred *and* paid for.

Although section EF 1(5)(b) refers to "payment", i.e. "the expenditure relates to *payment* for services; as does section EF 1(5)(d), i.e. "the expenditure relates to a *payment* for, or in relation to, a chose in action", there is nothing in the wording of the section to suggest that the word "payment" should be read down as only applying to situations where a payment has already been made. It is consistent with the terms of the provision to interpret it as referring to both past and future payments. In addition, the introduction of section EF 1(5)(c) now makes it very difficult to argue on a plain reading of the section that the meaning of incurred and payment should be read down. To do so would mean that section EF 1(5)(c) applies in a wholly different way than the other subsections.

The converse view is that there is at least some ambiguity as regards the scope of sections EF 1(5)(b) and 1(5)(d) because they refer to "payment", and this may be interpreted as requiring that actual payment has taken place. It may be suggested that this is more consistent with the ordinary meaning of the term. For example, *The New Shorter Oxford Dictionary* (Clarendon Press, Oxford, 1993) provides:

> **payment 1** An act, or the action or process, of paying. (Foll. by *of* the money etc. paid, the debt discharged, the payee; *for* the thing bought or recompensed.) **2** (A sum of) money etc. paid

In addition, some support for this interpretation comes from section EF 1(5A) which also uses the word "payment". For the purposes of section EF 1, that provision deems any payment to which section CB 12(1) applies 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. Section CB 12(1) refers to "an amount *paid* by an employer in respect of an employee's employment or service". In this context "payment" seems to require physical payment.

Given this potential ambiguity, it is necessary to look to the background to the introduction of the provision to try to ascertain its true meaning.

A preliminary point is that the section applies to "accrual expenditure" which, uses the term "incurred" – a common law concept that at the time of the introduction of section EF 1 (in 1987) was clearly understood as being wide enough to encapsulate future expenditure (this had been the understood position as early as 1938 with the decision in *New Zealand Flax Ltd v FC of T* (1938) 5 ATD 36).

The Consultative Document on Accrual Tax Treatment of Income and Expenditure (October 1986) recommended the introduction of a regime for the timing of deductions for expenses other than interest. Chapter 14 sets out the broad outline for what became section EF 1. Nothing in the general discussion indicates whether the Committee envisaged the provision applying to all incurred expenditure, or only to prepayments. However, all of the examples concern prepayment scenarios.

The comments made in the subsequent *Report of the Consultative Committee on Accrual Tax Treatment of Income and Expenditure* (April 1987) are also inconclusive in this regard. However, there is one indication that the focus may have been on prepayments. In Appendix III to the Report: *Recommendations of the Consultative Committee to the Minister of Finance*, in referring to the precursor to section EF 1(5)(a) and the change from a "delivery" test to a "use" test for goods, the following comment is made:

> Clause 12 of the amended Bill deals with how the accruals treatment will apply to the specified categories of expenditure, other than interest, outlined in your Budget. The treatment for non-interest expenditure in the Bill follows the treatment outlined in your Budget, with one exception. Your Budget announcement required the add-back of expenditure on goods only to the extent that the goods **were paid for** but not received by the end of the income year. Under clause 12 however, expenditure on goods must be added back where the goods have not been used at the end of the income year. Thus goods are treated in the same way as other types of accrued expenditure. That is, a deduction for the whole of the expenditure is allowed in the income year in which it is incurred but that part of expenditure related to future years is added back to the taxpayer's assessable income. This treatment is similar to the current treatment of expenditure incurred on trading stock and conforms with one of the options outlined in the Consultative Document. (*Emphasis added*)

From this statement it might be inferred that section EF 1(5)(a), at the very least, was only aimed at prepayments, i.e. that was the intention when it applied a "delivery" test, and the same approach applied under the eventually adopted "use" test. However, it is considered that the comments made about the regime being the same as for other types of accrued expenditure, and in particular the trading stock regime, seem to be somewhat at odds with that interpretation. For example, the definition of "trading stock" does not differentiate between payments actually made and future payments – trading stock is essentially what has been acquired or purchased at year-end, whether actually paid for or not. In addition, the definition of "trading stock" was amended in 1987 to expressly provide that it included "anything in respect of which expenditure is incurred after 23 October 1986 and which, if possession of that thing were taken, would be trading stock". Arguably, the reference to "incurred" makes it even clearer that the trading stock regime operates on an accruals basis, i.e. recognising all expenditure that has been incurred at year-end, regardless of whether that expenditure has been physically paid out.

Although not completely free from doubt, it is considered that the better view is that section EF 1 is not limited to pre-payments. The concept of "incurred" expenditure is clearly wider. Although the examples provided in the consultative documents referred to above all dealt with pre-payment situations, there is nothing in the background to the provision's enactment that expressly limits it in that way. (In this regard it should be noted that in cases such as *Marac Life Assurance Limited v CIR* (1986) 8 NZTC 5,086, at pages 5,093, 5,095, 5,100 and 5,104 and *CIR v Dewavrin* (1994) 16 NZTC 11,048 at page 11,054, the Court of Appeal noted a word of caution regarding taking into account background discussion papers as being indicative of the underlying purpose of any provision or as necessarily identifying the mischief that the legislation was designed to counter. Although such background material may be helpful, it is always necessary to look at the plain words of the legislation actually promulgated to determine what Parliament intended.) In addition, since the enactment of section EF 1(5)(c), it is considered very difficult from an interpretative stance to read the other subsections down in the manner suggested. This statement therefore proceeds on the basis that section EF 1 potentially applies to all *incurred* accrual expenditure.

It is also noted that this result is consistent with the comments made by Inland Revenue in Technical Policy Circular 88/2 (Part 2), the text of which was subsequently published in the same form in Public Information Bulletin No 167 (December 1987). Although the examples given all involve pre-payments, the perceived mischief is stated more broadly (at page 51) as being the ability to take a deduction for expenditure that has been incurred, but not paid for:

Mischief

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. (*Emphasis added*)

It is also interesting to note that the taxpayer in *Thornton Estates Ltd. v CIR* (1998) 18 NZTC 13,577 argued before the Court of Appeal (at page 13,582) that section EF 1 was directed at pre-payments, and particularly at payments for consumable aids. Although this argument is not addressed in the reasoning, it seems implicit in the decision reached that the Court did not see the provision as being limited in anyway to pre-payments.

Application to deductions for warranty costs

The Privy Council in *Mitsubishi* held that the taxpayer 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.

The expenditure in question was the estimated warranty costs. This type of 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. (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 paragraph (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.)

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 (section EF 1(5)(a)), payment for services (section EF 1(5)(b)), or payment for, or in relation to, a chose in action (section EF 1(5)(d)).

Each subsection uses the phrase "relates to", e.g. the relevant expenditure must *relate to* the purchase of goods. Given this, before considering the application of each part of section EF 1 to warranty expenditure it is useful to consider the meaning of that phrase. This issue is key to determining the potential breadth of the provision.

"relates to"

The meaning of "relates to" in section EF 1 has not 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.

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A leading case on the meaning of "in respect of or *in relation to*" is *Shell New Zealand Ltd v CIR* (1994) 16 NZTC 11,303. 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, given that the words "in relation to" appear as a compound term in section 2 with the words "in respect of", it is arguable that their scope is naturally broader in that context.

In *Department of Internal Affairs v Poverty Bay Club Inc* [1989] DCR 481, 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".

In the High Court decision *Picture Perfect Ltd v Camera House Ltd* [1996] 1 NZLR 310, Barker J considered the 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, however he observed that the interpretation of "relates" in this context could involve either a flexible or restrictive approach. He noted that it had been suggested that the preferable interpretation in the context before him 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.

The Supreme Court of Canada also gave a wide interpretation to the words "relating to" in *Slattery (Trustee of) v Slattery* [1993] 2 CTC 243. 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.

From this analysis it is considered that "relates to" 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.

Having considered the potential meaning of "relates to", it is necessary to consider the ordinary meaning of the words of sections EF 1(5)(a), (b) and (d) as they might apply to warranty expenditure.

Section EF 1(5)(a) - Goods

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.

It is considered that in the context of warranty expenditure, section EF 1(5)(a) could be interpreted as potentially applying to:

- the purchase price of goods acquired for, and paid (or to be paid) for by, the taxpayer; and/or
- the purchase price of goods acquired by a third party, but paid for (or to be paid for) by the taxpayer (although only to the extent that such expenditure is deductible under section BD 2(1)(b) in the first instance); and/or
- expenditure paid for (or to be paid for) by the taxpayer, being ancillary, or *relating to*, the purchase of any such goods (e.g. freight, custom or other transportation charges).

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

However, it is acknowledged that an alternative, and potentially wider, interpretation of section EF 1(5)(a) is possible. It is 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* (the warrantor) 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. Taking this wider approach, it can then be argued that the warranty expenditure which a warrantor may incur *relates to* the purchase of goods, i.e. the purchase of vehicles by consumers.

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....

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.

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".

Preliminary conclusion on the words of section EF 1(5)(a)

It is unclear 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* it is considered that the better view is that the section is limited in this way. As seen, "relates to", and similar phrases, have generally been given a broad interpretation by the courts, although the breadth of their meaning tends to be influenced by the legislative context. Arguably, if Parliament had intended to apply section EF 1(5)(a) to both purchases *and sales* it could have provided for this expressly. It is considered that the better view of the meaning of "relates to" is 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.

In the context of warranty expenditure, adopting this interpretation means that section EF 1(5)(a) does not apply to payments made by taxpayers (warrantors) for the cost of goods applied to remedy defects under warranties.

Section EF 1(5)(b) – Services

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 New Shorter Oxford Dictionary* (Clarendon Press, Oxford, 1993) defines "service" as:

> **IV 18** Provision of a facility to meet the needs or for the use *of* a person or thing…**20** Assistance or benefit provided to someone by a person or thing;…**21a** An act of helping or benefiting another; an instance of beneficial, useful, or friendly action. **b** The action of serving, helping, or benefitting another…
>
> **B** ***vt*** **1** Be of service to; serve; provide with a service. **2** Perform maintenance or repair work on (a motor vehicle etc.)

Section EF 1(5)(b) applies where the expenditure in question relates to payment *for* services. As for section EF 1(5)(a), in the context of warranty expenditure section EF 1(5)(b) could be interpreted as potentially applying to:

- the cost of services supplied to the taxpayer and paid (or to be paid) for by the taxpayer; and/or
- the cost of services supplied to a third party, but paid (or to be paid) for by the taxpayer (subject to being deductible under section BD 2(1)(b) in the first instance); and/or
- expenditure paid (or to be paid) for by the taxpayer, being ancillary, or *relating to*, the payment for any such services.

To determine if, and how, section EF 1(5)(b) might apply to warranty expenditure, it is necessary to ask whether any "services" have been or will be provided, and whether "payment" has been made for those services by the warrantor. 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 (the warrantor).

It may be arguable that dealers, in providing repair work to customers, also provide a "service" to their distributor/manufacturer 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 warrantor pays dealers to provide repair services to customers.

It is considered that the repair services provided by dealers to customers, to the extent to which they are *not paid for by* the warrantor, 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", it is considered that the reference to "for" in section EF 1(5)(b) 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 interpretation of section EF 1(5)(a) discussed above, i.e. that the section only applies if the taxpayer has *paid for* (or will be obliged to *pay for*) the goods in question. It is considered reasonable to assume that Parliament intended for there to be consistency between the various subsections where the same words, i.e. "relates to", are used. For these reasons, it is considered 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 (the warrantor) seeking the deduction.

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Accepting that section EF 1(5)(b) does not apply to services provided to third parties and not paid for, or to be paid for, by the warrantor, the question becomes whether it could apply to the relationship between dealers and warrantors. The issue becomes whether it is possible to say that:

- the warrantor has paid for, or is obliged to pay for, *services supplied to it* by the dealer; or
- the warrantor has paid for, or is obliged to pay for, the repair *services provided to customers*.

In either case it would then be arguable that section EF 1(5)(b) applies to require the adding back of the future estimated warranty expenditure by the taxpayer.

Has the taxpayer paid for services supplied to it by the dealer?

In most situations, warrantors require dealers to process warranty claims and undertake 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 warrantor. It might be argued that, to that extent, dealers do also provide a "service" to the warrantor, i.e. repair work for a third party, but for the indirect benefit of the warrantor. It is arguable that the warrantor makes payment for those services in the form of the reimbursement of the cost of the repairs (and replacement parts).

It is acknowledged that some support for this analysis is available in the Taxation Review Authority decision *Case R34* (1996) 16 NZTC 6,190 and the supplementary decision dealing with the same facts and taxpayer, *Case S88* (1997) 17 NZTC 7,551. 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 the taxpayer in *Mitsubishi* 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.

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 *Mitsubishi*, (e.g. in these cases the warranty was provided by the distributor to the customers, whereas in *Mitsubishi* warranties were given by the dealers to customers, rather than by the taxpayer, through the dealers). However, they do 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, also provides those repair services to the manufacturer who in turn provides a warranty to that distributor.

However, there is a contrary argument. That 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, i.e. the warrantor. 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 service to the party that reimburses them for the cost of providing those services.

Has the taxpayer paid for services supplied to customers?

Even if it is accepted that no services have been supplied to, and paid for by, the warrantor, it is arguable that section EF 1(5)(b) might still apply on the basis that the taxpayer has paid for (or is obliged to pay for) the services supplied to customers. However, for the reasons set out above, the section will not apply if the relationship is not one of "payment *for* services". The better view is that it will not apply where there is only a reimbursement or indemnification of services provided to a third party.

Preliminary conclusion on the words of section EF 1(5)(b)

It is considered that the above analysis demonstrates that it is not possible to decide the exact scope of section EF 1(5)(b) by simply considering the ordinary meaning of the words used. This is because the words used may be interpreted in different ways.

A broad interpretation tends to indicate that the resolution of these issues in any particular case will depend on the exact terms of the relevant dealership arrangements, including establishing who provides the warranty and on what basis. In particular, in this context the application of section EF 1(5)(b) seems to turn on whether the warrantor is paying *for* the services of the dealer under the warranty arrangement, or paying *for* services to be provided by the dealer to customers, compared to a situation where the warrantor is simply reimbursing or indemnifying the dealer for fulfilling obligations under the warranty. In the former case, it is arguable that given the language of section EF 1(5)(b) it potentially applies; in the latter situation it does not. However, even if this interpretation is sustainable, it is considered at least questionable as to whether these distinctions were intended by Parliament to be determinative of the application of the section in this context.

On the other hand, a narrow interpretation of section EF 1(5)(b) would tend to indicate that the provision is limited to situations where the taxpayer is paying for services (and/or ancillary expenses) provided for its own benefit.

Given this ambiguity, in accordance with the approach to statutory interpretation endorsed in cases such as *CIR v Alcan New Zealand Ltd.* (1994) 16 NZTC 11,175, in order to determine the scope of the provision it is necessary to look beyond the words of section EF 1 and consider its underlying purpose. This is discussed below.

Section EF 1(5)(d) - Choses in action

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.

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": *Torkington v Magee* [1902] 2 KB 427, 430. A warranty is an enforceable right under a contract and as such is a chose in action.

Section EF 1(5)(d) applies to expenditure which *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 warranty 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; and/or
- the payment by the taxpayer for, or in relation to, a chose for the benefit of a third party; and/or
- expenditure paid for by the taxpayer, being ancillary, or *relating to*, the payment for any such chose in action.

As for sections EF 1(5)(a) and (b), because of the phrase "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 considered 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 for either the benefit of the taxpayer or a third party. It is considered that the words "relates to" must be read in the light of the word "for".

As for section EF 1(5)(b), this analysis then raises the question of whether a warrantor 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 warrantor's. 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 warrantor. Again, it is considered that 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 warrantor to dealers. On a literal interpretation of section EF 1(5)(d), it is acknowledged 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/warrantor seeking the deduction, the provision may apply.

"in relation to"

In addition, unlike sections EF 1(5)(a) and 1(5)(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 that Parliament intended to broaden the application of section EF 1(5)(d), when compared with sections EF 1(5)(a) and 1(5)(b).

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 warrantor 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.

However, such an interpretation of section EF 1(5)(d) requires reading the words "for, or in relation to" disjunctively. That is, the section will apply even if the taxpayer has not made any payment *for*, or is obliged to make any payment *for*, the acquisition of the underlying chose in action. Provided that a payment has been made *in relation to* that chose, that will be 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 acknowledged 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. Unless it

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can be accepted that the words are simply otiose, principles of statutory interpretation suggest that the words "in relation to" have a meaning distinct from the words "relates to". One possible meaning for the phrase would be that it extends the provision to apply to expenditure which merely relates to a third party's chose in action. On this basis section EF 1(5)(d) would be potentially wide enough to cover a deduction for future estimated warranty costs made by a warrantor.

A further difficulty with adopting a broad interpretation of section EF 1(5)(d) arises out of the way in which the unexpired portion is calculated. The provision states that the amount of the unexpired portion is "the amount that relates to the unexpired part of the period, in relation to which the chose is enforceable". In the context of warranty expenditure it is difficult to find a relationship between that expenditure and the warranty period. This method of calculating the unexpired portion of the accrual expenditure suggests that section EF 1(5)(d) was intended to apply to the cost of acquiring choses in action for the taxpayer's own benefit, rather than other types of payment relating to a third party's chose in action.

Preliminary conclusion on the words of section EF 1(5)(d)

As for section EF 1(5)(b), section EF 1(5)(d) permits of more than one interpretation.

Applying a broad interpretation, the provision potentially applies to all warranty expenditure to the extent that the terms of any particular warranty arrangement involves the warrantor *paying for* the underlying warranty, although not for its own benefit, but for the benefit of the customer. This is consistent with the wide judicial interpretation that tends to be given to the phrase "relates to". In addition, the inclusion of the phrase "in relation to", suggests that section EF 1(5)(d) is broad enough to encompass such payments.

A narrower approach would restrict the provision to situations where the taxpayer is paying for a warranty (and/or ancillary expenses) where the warranty is for its own benefit.

As for section EF 1(5)(b), given this ambiguity, it is considered that in order to determine the scope of section EF 1(5)(d) it is necessary to look beyond the words of the provision and consider the underlying purpose of section EF 1, as may be determined from the legislative background to the provision, and relevant case law.

Purpose of section EF 1

Legislative background

Section EF 1 forms part of the accruals regime enacted in 1987. As previously noted, the *Consultative Document on Accrual Tax Treatment of Income and Expenditure* (October 1986) proposed a test of delivery (rather than the current "use" test) for expenditure relating to the purchase of goods. 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 seems clear that the goods in question had to be goods acquired *by* the taxpayer seeking the deduction.

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 of (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.
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> ...
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> **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*)

It is considered that 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.

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. A "use test" makes it at least arguable that the goods do not have to be those of the taxpayer (on a broad interpretation 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 than the former delivery test. 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.

Statements by Inland Revenue released shortly after the enactment of the precursor to section EF 1 also tend to show that the focus was on goods, services, or choses acquired *by* the taxpayer for the direct benefit of the taxpayer seeking the deduction, with the timing of that deduction being linked to the application of that expenditure to the production of assessable income: Public Information Bulletin No 167 (December 1987), paragraphs 14 and 35.

Case law

Section EF 1 has recently been considered by the Court of Appeal, on appeal from the High Court decision: *Thornton Estates Ltd. v CIR* (1995) 17 NZTC 12,230. The case concerned a property developer which acquired land for development. In the year of acquisition it claimed a deduction for the cost of the land, development 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, alternatively, any expenditure on purchasing and developing the land, as a corresponding revenue item.

High Court

Hansen J held that although the taxpayer was entitled to a deduction for the expenditure (under the equivalent to section BD 2(1)(b)), this was subject to the application of section EF 1. Section EF 1(5) applied to the purchase of goods, which included real property.

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.

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. (*Emphasis added*)

Court of Appeal

In an unanimous decision the Court disallowed the taxpayer's appeal. The Court found that where a land developer is entitled to deduct expenditure on the acquisition and development of land, section EF 1 requires that that part of the expenditure which relates to land still on hand at balance date must be added back under section EF 1(1). This result was considered to be consistent with the purpose of section EF 1 – to match deductible expenditure and revenue production. Richardson P noted (at page 13,581):

> A crucial problem addressed by the special regimes [financial arrangements, leases of personal property and accrual expenditure] was that the timing of tax deductions and income recognition was not symmetrical. In particular expenditure might be deductible much earlier than when the income to which it related would be assessable. The mismatch allowed taxpayers scope to defer taxes even where there was a resulting asset held in the interim on revenue account, depending on the terms of the general legislation.
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> …
>
> **The obvious purpose implicit in s[EF 1] is to match deductible expenditure and revenue production.** The section focuses on the effect of expenditure in the current year by bringing into account as income and thereby offsetting the expenditure by that part of the expenditure which remains attributable to the future period.

In discussing the scheme of section EF 1, his Honour went on to note (at page 13,582):

> The next step in the **statutory matching scheme** is to ascertain the extent to which the effect of expenditure is referable to the subsequent year. Under the description of "the unexpired portion ... of any amount of accrual expenditure" paras (a), (b) and (c) of s104A [paras (a), (b) and (d) of sEF 1(5)] deal with goods, services and choses in action respectively. Under (b) the unexpired portion is "the amount of expenditure incurred on services performed". Under (c) the unexpired portion is "the amount that relates to the unexpired part of the period in relation to which the chose is enforceable". Under (a) the unexpired portion is "the amount of expenditure incurred on goods not used in the production of assessable income". In all three cases the apportionment is time related: under (a) it is the goods yet to be used; under (b) it is the services yet to be performed; and under (c) it is the amount for which the charge is then enforceable. **In harmony with (b) and (c) the assumption underlying (a) is that the extent that goods, including land, have not been used in the production of assessable income, the amount of the accrual expenditure is not attributable to the income year when the expenditure was incurred but belongs to the next year and subsequent years. The subsection proceeds on the premise that in such cases the effect of the expenditure is not spent** and there is an unexpired portion of expenditure to be included in the assessable income for the income year (subs(4) [subs(1)]). (*Emphasis added*)

The Court of Appeal rejected the taxpayer's argument that "used" in the precursor to section EF 1(5)(a) meant "employed, applied, committed or dedicated", preferring the meaning "used up". That meaning was considered to be consistent with the matching purpose of the legislation (at page 13,583):

> The obvious purpose of the accruals provision is to achieve **a closer matching of the timing of deductions and income recognition for tax purposes. To that end s104A [sEF 1]**

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allows the taxpayer the benefit of the deduction as and when goods purchased on revenue account are expended through being consumed or incorporated into other assets The net result reflecting the income earning activity is that while the expenditure is deductible in full the unexpired portion is brought back in as assessable income, the assumption being that the difference, i.e. **the expired portion, has been reflected in product sales or in products on hand** The contrary interpretation espoused by Mr Martin ignores the continued existence and continuing availability for the use of the land in its then state beyond the income year. That interpretation would produce an irrational result turning on how much of the land has been subjected to development work rather than what was still on hand at the end of the income year. **It would also undermine the purpose of the accruals regime and would be inconsistent with generally accepted accounting principles and commercial practice** (*Emphasis added*)

The Court of Appeal upheld the High Court decision and confirmed that the underlying purpose of section EF 1 is to match the timing of the deduction of revenue expenditure with the production of assessable income to which it relates.

Notwithstanding these comments, in seeking to determine what is the underlying purpose of section EF 1, it is acknowledged that an alternative argument may be made. On the basis of the language of section EF 1(5) it is arguable that the purpose of the legislation is to match the timing of deductions for expenditure with the *actual 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), rather than the income derived by virtue of such expenditure. The matching of the timing of deductions with the benefit through consumption derived from such expenditure will not always correspond with the matching of deductions and the production of income from that expenditure.

In *Thornton Estates*, the Court of Appeal was not confronted with a situation where, although the expenditure in question had been used to derive income (product sales), the direct benefit of that expenditure had not yet arisen (e.g. benefits flowing to a third party under a warranty in terms of the provision of goods and services to repair defective vehicles). In that case, at the time the deduction was taken for the expenditure, although arguably the taxpayer had received the direct benefit of that expenditure (e.g. goods and services acquired to develop the land), it had not been used to derive income. This would only arise when, and to the extent that, the land was subsequently sold.

Notwithstanding this difference, it is considered that the Court of Appeal decision stands for the principle that section EF 1 should be interpreted in a way that is consistent with the matching of expenditure and income. Applying such an approach to the facts in *Mitsubishi* leads to the result that section EF 1 does not apply because its application causes a mis-matching of the timing of the deduction (for warranty costs) with the income that flows from that expenditure (vehicle sale proceeds). This is also inconsistent with generally accepted accounting principles and commercial practice as referred to by the Court of Appeal in *Thornton Estates*, and by the Privy Council in reaching their decision in *Mitsubishi*.

Conclusions

Inland Revenue considers that section EF 1 is not limited to pre-payments of accrual expenditure and therefore has potential application to future estimated warranty expenditure.

It is acknowledged that it is possible to argue that the words of section EF 1, when applied to the same or similar facts to those in *Mitsubishi*, are wide enough to cover expenditure incurred by a warrantor. This would be on the basis that the warranty expenditure relates to payment for services (either provided to the warrantor or to the customer), or because it is for, or in relation to, a chose in action (the warranty). However, it would appear that a payment which is a reimbursement or indemnification for the cost of services provided, as distinct from a payment for services, is not covered.

In the case of services, applying section EF 1 means that the expenditure is not deductible until the warranty has been honoured by the performance of the repair services. In the case of a chose, the expenditure would need to be spread over the period of the underlying warranty. However, it is unclear on the words of the provision which subsection (section EF 1(5)(b) or 1(5)(d)) would apply in any particular case. (The result will be different given the different way in which the unexpired portion is calculated.) It is also unclear why Parliament would have intended a wider interpretation to apply to services and choses in action, than to goods – the better view of section EF 1(5)(a) being that it is limited to payments for goods acquired for the benefit of the taxpayer.

It may be suggested that this difficulty of classification stems from the fact that although estimated future warranty expenditure may be for the future supply of particular goods or services (repair of the defective vehicle), prima facie they are payments made to honour a warranty. That is to say, they are first and foremost warranty costs.

Given this uncertainty on the words of the provision, it is necessary to consider the underlying purpose of section EF 1 as demonstrated by the legislative background to the provision, and considered by the courts (most notably the Court of Appeal in *Thornton Estates*). That analysis shows that the section is aimed at achieving matching of the timing of deductions with the income flowing from that expenditure and should be interpreted in a way that is consistent with that purpose.

To apply section EF 1 to facts analogous to those arising in *Mitsubishi* would result in a taxation treatment that differs from matching in those terms. Therefore, Inland Revenue accepts that section EF 1 does not apply to require the adding back of warranty expenditure in the same or similar factual situations to those which arose in *Mitsubishi*.