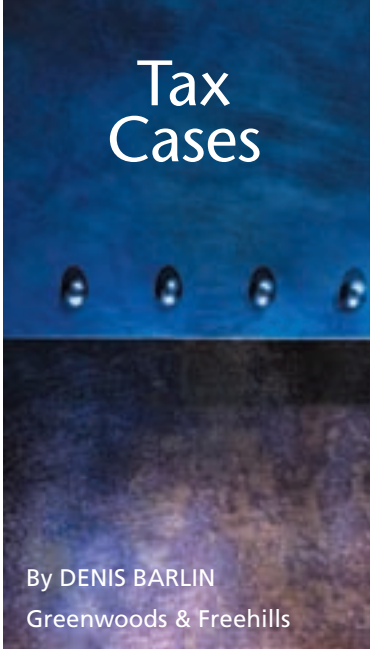

Re Pech and FCT AATA 573[2001]

Deductible expenses for infringement of trademark

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Senior Member MD Allen of the Administrative Appeals Tribunal handed down a decision AAT Case [2001] AATA 573, Re Pech and FCT on 22 June 2001, finding that legal expenses incurred in defending a claim that a trademark had been infringed were an allowable deduction.

The Facts

Jiri and Glenda Pech ("the taxpayers") entered into a business agreement with David Machon in October 1994. Under the agreement, the taxpayers were to manufacture trailers, with Machon to manufacture canvass tops for the trailers. An agreed name of the trailer "nockAbout", was stencilled into the trailer.

In November 1995, the taxpayers registered the business name "nockAbout Trailers". At the same time, Machon registered the trademark "nockAbout Campers", contrary to an agreement between the taxpayers and Machon. However, Machon informed the taxpayer that he would not prevent the taxpayers from using the word "nockAbout".

In April 1996, the relationship between the taxpayers and Machon broke down. Machon brought legal action against the taxpayers to restrain them from using the trademark "nockAbout", which resulted in legal expenses for the taxpayers in:

- defending a claim that a trademark was infringed;
- defending an alleged breach of the *Trade Practices Act* 1974 (Cth), and the *Fair Trading Act* 1987 (NSW), as a result of the use of the trademark; and
- a counter-claim initiated by the taxpayers that the trademark was fraudulently registered.

The taxpayers claimed an amount of $18,871 as deductible legal expenses under Section 8-1 of the *Income Tax Assessment Act* 1997 (Cth). Section 8-1 allows a general deduction for losses or outgoings where they are in connection with producing income or business activities, and are not of a private, domestic or capital nature. The Commissioner disallowed the deductions, and the taxpayers sought review of the Commissioner's decision in the Administrative Appeals Tribunal.

Characterisation of the Legal Expenses

Senior Member Allen referred to the decision of Hill J in *Smithkline Beecham Laboratories (Australia) Ltd v Federal Commissioner of Taxation* 93 ATC 4629, who stated that regard must be given to the purpose of the taxpayer incurring an expenses in order to determine whether it is deductible in the hands of the taxpayer. In the judgement, Hill J referred to this as

> ...expenditure incurred in the course of litigation, that requires consideration to be given of the purpose of the taxpayer in undertaking that litigation.

It was recognised that generally, there are two types of expenditure, being those that are:

- made to bring into existence or procure an asset or advantage of a lasting nature to enure for the benefit of the profit-earning subject, which would ordinarily be on capital account
- within a very wide class of things which in the aggregate form the constant demand which must be answered out of the returns of a trade or its circulating capital, which would ordinarily be of a revenue nature.

That is, costs which refer to the operation of a business, are generally of a revenue nature; whereas the costs referable to the profit-making structure of the business are generally of a capital nature.

The AAT distinguished between two types of expenditure relating to legal expenses. The first is expenditure incurred to preserve or protect a business, which is ordinarily expenditure of a capital nature. The second is expenditure incurred in defending criticism of methods of trading, which is ordinarily of a revenue nature.

It was recognised that the distinction between income and capital is dependent upon the distinction between the profit yielding structure on the one hand and the process of operating it on the other. As Hill J in Smithkline stated:

> Relevant to the distinction ... is a difference between an outlay which is recurrent, repeated or continual on the one hand, and an outlay which is final or made 'once and for all' on the other. Expenditure made to bring into existence or procure an asset or advantage of a lasting nature to enure for the benefit of the profit-earning subject would ordinarily be on capital account as distinct from expenditure which falls: 'within the very wide class of things which in the aggregate form the constant demand which must be answered out of the returns of a trade or its circulating capital...

Further, regard was given to Case 21 11 CTBR (NS) 96, in which legal expenses for litigation to establish the freedom to manufacture articles from patented designs was not considered to be of a capital nature. There, it was found that:

> If the freedom sought had been established no new product would have been produced nor even, on the evidence, a more efficient one. A conclusion that increased sales may have been expected would not be justified. It seems that all that would have been involved was increased efficiency of the profit-yielding subject resulting from the course of operations of the business.

Finding

It was held that the legal expenses incurred by the taxpayers was in relation to their defence that they had been granted a licence by Machon.

Senior Member Allen found that the intention of the taxpayers in defending the allegations was to maintain a right to use the word "nockAbout" as a name or brand on the trailers manufactured. While it was found that the right was given to the taxpayer, and could have been revoked at any time and at will by Machon, the legal costs incurred were not to defend an asset but to defend the way in which the taxpayers conducted their business. Therefore, the expenses were viewed as deductible expenses.

Senior Member Allen found that the expenditure did not procure for the taxpayers a future permission for the use of the trademark. Rather, the legal proceedings were to defend a right that the taxpayers had in relation to the past use of the trademark. That is, the expenses on legal costs were incurred to defend the way in which the taxpayers business was conducted, by using part of the trademark 'nockAbout Campers', and to avoid incurring a penalty (damages) for the alleged unauthorised use of the trademark or for passing off.

Conclusion

The decision in Re Pech upholds the general principle that expenses incurred which go to the operation of a business are of a revenue nature, and therefore deductible in the hands of the taxpayer. However, expenses which go to the profit making structure of a business are of a capital nature and not deductible. ■

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