No. 1215—HIGH COURT OF JUSTICE (KING'S BENCH DIVISION)—3RD, 6TH AND 9TH MAY, 1940

COURT OF APPEAL—4TH, 5TH AND 8TH JULY AND 2ND AUGUST, 1940

HOUSE OF LORDS—10TH, 12TH, 13TH AND 16TH FEBRUARY AND 27TH APRIL, 1942

# THOMAS FATTORINI (LANCASHIRE), LTD. *v.* COMMISSIONERS OF INLAND REVENUE(1)

*Sur-tax—Undistributed income of company—Finance Act*, 1922 (12 & 13 *Geo.* V, *c.* 17), *Section* 21.

*The Appellant Company which was registred in* 1919 *took over and carried on until* 1928 *the business formerly carried on by T. In* 1928 *the Company ceased to trade on its own account and invested its funds on loan at interest with three other companies (the " operative companies "). T, at the time of his death in* 1934, *was the principal shareholder in all four companies. By his will his two sons were given the option to purchase his shares in these companies from his executors. One son, F, did not exercise his option; the other, W, bought all his father's shares in the Appellant Company. Thenceforward, W and his wife were the only shareholders in the Company.*

*In* 1936, *the Company bought all the shares held by F in the three operative companies and later in the year it bought all the shares in those companies held by W and by the executors of his father's will. To finance the latter transaction, the Company borrowed a sum of money from a bank under an agreement which provided,* inter alia, *that until all moneys advanced with the interest thereon had been repaid, the Company should pay over to the bank all dividends received from its shares in the three operative companies. For* 1936–37 *and* 1937–38 *the Company had no income other than the dividends from those companies and it paid no dividend itself for either of those years.*

*Directions under Section* 21, *Finance Act*, 1922, *that the actual income of the Appellant Company for* 1936–37 *and* 1937–38 *should be deemed to be the income of the members of the Company for the purposes of assessment to Sur-tax were discharged, on appeal, by the Special Commissioners, but the Board of Referees, on a re-hearing of the appeal, decided that the directions should be restored.*

Held, *that the directions had been correctly discharged and that on the evidence the finding of the Board of Referees could not be sustained.*

Glazed Kid, Ltd. *v.* Commissioners of Inland Revenue, 15 T.C. 445, *disapproved.*

## CASE

Stated by the Board of Referees pursuant to the Finance Act, 1922, First Schedule, Paragraph 2, for the opinion of the High Court of Justice.

1. At a meeting of the Board of Referees held on 20th April, 1939, for the purpose of re-hearing appeals under the above-mentioned Act, we, the members of the said Board present at the said meeting, re-heard an appeal

(1) Reported (C.A.) [1940] 3 All E.R. 657; (H.L.) [1942] A.C. 643.

by Thomas Fattorini (Lancashire), Ltd. (hereinafter called " the Company "), against directions made by the Commissioners for the Special Purposes of the Income Tax Acts (hereinafter called " the Special Commissioners ") under Section 21 of the Finance Act, 1922, as subsequently amended, whereby they directed that for the purposes of assessment to Sur-tax the actual income of the Company from all sources for the years of assessment 1936–37 and 1937–38 respectively should be deemed to be the income of the members and the amount thereof apportioned among them.

2. The Company being aggrieved by the said directions appealed against the same to the Special Commissioners who upon the hearing thereof did on 22nd November, 1938, determine that the said directions should be discharged.

3. The Commissioners of Inland Revenue being dissatisfied with the said determination required the said appeal to be re-heard by the Board of Referees and we re-heard the same accordingly.

4. The Company was incorporated on 9th April, 1919, with a nominal capital of £25,000 divided into 15,000 ordinary shares of £1 each and 10,000 preference shares of £1 each of which 15,000 ordinary shares and 1,765 preference shares have been issued as fully paid up.

5. The objects for which the Company was established were, *inter alia*, as follows:—

(*a*) To carry on at such places in the United Kingdom or elsewhere, as may be determined by the directors of the Company, all or any of the businesses following, that is to say the businesses of jewellers, gold and silver smiths, and dealers in any kind of metal, curiosities, articles of vertu, coins, medals, badges, stampings, plate, jewellery, watches and precious stones, and as manufacturers of any of the above articles; and as bankers, brokers, commission agents, and general merchants; and generally to carry on the said businesses in all their branches, or any business of character similar or analogous to the foregoing, or any other business or any other works or manufactures which may seem to the Company capable of being conveniently carried on in connection with the above, or calculated directly or indirectly to enhance the value of or render profitable any of the property or rights of the Company or further any of its objects.

(*b*) To acquire by purchase and to take over as a going concern the business now carried on at 19 Knowsley Street, Bolton, in the County of Lancaster, under the style or firm of Thomas Fattorini, including trade marks, stock-in-trade, machinery, plant, utensils, tools, fixtures and fittings, goods manufactured and in the course of manufacture, raw and other materials, patents, patent rights, copyrights, contracts, and generally all or any of the assets of the said firm whatsoever.

(*c*) To enter into partnership or into any arrangement for sharing profits or to amalgamate with any person or company carrying on or about to carry on any business which this Company is authorized to carry on, or any business or transaction capable of being conducted so as to benefit this Company. To take, or otherwise acquire, and hold shares in any other company having objects altogether, or in part, similar to those of this Company, or carrying on any business capable of being conducted so as directly or indirectly to benefit this Company.

(*d*) To invest and deal with the moneys of the Company not immediately required in such manner as may be from time to time determined.

6. On 1st June, 1919, the Company agreed with Thomas Fattorini to acquire and did acquire from him all the stock-in-trade and other loose effects of the retail jewellery and mail order business referred to in paragraph 5 (*b*) above. Nothing was to be paid by the Company for goodwill and no book debts owing to Thomas Fattorini at the time were to be taken over. The purchase price was to be ascertained by valuation of the assets in the ordinary course of trade and was in fact so ascertained to be the sum of £14,754 19*s*. 5*d*. which was attributable to the assets purchased as follows:—

| | | | |
|---|---|---|---|
| Stock-in-trade ... ... ... | £10,175 | 19*s*. | 3*d*. |
| Fixtures and fittings ... ... ... | £1,750 | 0*s*. | 0*d*. |
| Cash at bank and in hand ... ... | £2,829 | 0*s*. | 2*d*. |

Attached hereto, marked " A ", and forming part of this Case(1) is a copy of a memorandum dated 1st June, 1919, embodying the said agreement and having endorsed thereon a receipt signed by Thomas Fattorini for the sum of £14,754 19*s*. 5*d*. The said purchase price of £14,754 19*s*. 5*d*. was satisfied as to £2,754 19*s*. 5*d*. in cash and as to £12,000 in fully paid shares of the Company. Also attached hereto and forming part of this Case(1) are the following documents, marked " B " and " C " respectively:—

(i) A bundle containing copies of the trading accounts and balance sheets of the business of Thomas Fattorini for the last two completed years of his individual trading, viz., the two years ended 13th May, 1919.

(ii) The first trading account and balance sheet of the Company prepared after it took over the business in 1919, viz., a trading account for the year ended 11th May, 1920, and a balance sheet of the like date.

7. The said business so acquired by the Company was carried on by it until the year 1928. During the years 1919 to 1928 the Company expended on the purchase of stock-in-trade the aggregate sum of £170,224. Attached hereto, marked " D ", and forming part of this Case(1) is a bundle containing copies of the trading accounts for the last three years of the Company's trading and balance sheets as at 17th February, 1926, 14th February, 1927, and 13th February, 1928.

8. The said Thomas Fattorini who held 10,100 ordinary shares in the Company was the principal shareholder therein until his death in June, 1934. At the date of his death he was also the principal shareholder in three other companies (hereinafter called " the operative companies "), namely, Thomas Fattorini (Skipton), Ltd., incorporated on 16th April, 1919, which carried on a jewellery and mail order business at Skipton; Thomas Fattorini (Birmingham), Ltd., subsequently known as Thomas Fattorini, Ltd., incorporated on 24th February, 1919, which carried on the business of manufacturing medals and badges at Birmingham; and H. Pearson, Ltd., incorporated on 23rd March, 1915, cycle dealers. Thomas Fattorini acquired the shares in the last-named company in or about November, 1919, and in 1924 the cycle business ceased and H. Pearson, Ltd. thenceforth carried on a mail order business at Manchester.

9. In 1928 the jewellery business of the Company was discontinued and its mail order business was sold to Thomas Fattorini (Skipton), Ltd. On the Company ceasing to trade in the year 1928 a sum of £14,000, the consideration received by the Company for the sale of its mail order business as aforesaid, was invested at interest in the operative companies.

10. Thomas Fattorini died on 9th June, 1934, leaving two sons, Frank Fattorini and Wilfred Fattorini, and three daughters. The estate of the

(1) Not included in the present print.

deceased, the residue of which was left on trusts declared by his will, consisted principally of the shares held by him in the Company and in the operative companies, and his two sons Frank and Wilfred were given the option to buy such shares from the executors other than certain shares which had been specifically bequeathed by the testator's will. The son Frank Fattorini, who was not actively interested in the businesses, did not desire to purchase any of the said shares and Wilfred Fattorini thereupon arranged to do so. Accordingly Wilfred Fattorini acquired the deceased's holding of 10,100 ordinary shares in the Company and was in due course registered as the holder thereof, the date of registration of transfer in the Company's books being 17th September, 1936.

11. In the course of the year 1936 the Company took steps to acquire shares in the operative companies and in April of that year entered into a verbal agreement with Frank Fattorini to purchase from him, at a price of £18,229, shares in the operative companies held by him. The shares so purchased from Frank Fattorini were as follows:—

| *No. of Shares* | *Type of Share* | *Name of Company* | *Price* |
|---|---|---|---|
| 600 | Ordinary | Thos. Fattorini, Ltd. .. .. | £772 |
| 3,600 | Preference | Thos Fattorini (Skipton), Ltd. .. | £3,600 |
| 1,200 | Ordinary | do. .. | £2,607 |
| 5,000 | do. | H. Pearson, Ltd. .. .. .. | £11,250 |
| | | *Total price paid* .. .. .. | £18,229 |

The Company paid for the said shares in cash out of its own resources and the said shares were transferred to it on 24th August, 1936.

12. By an agreement in writing made the 22nd September, 1936, between the Company of the one part and Martins Bank, Ltd., of the other part, it was recited that the Company was desirous of purchasing the shares specified in the schedule to the said agreement. This recital was not accurate as the schedule included the shares mentioned in paragraph 11 which had already been purchased by the Company.

13. The said agreement further recited that the moneys at the disposal of the Company were insufficient to enable the Company to complete the purchase of the said shares and it had accordingly applied to the said bank for an advance of the balance of such moneys not exceeding £108,000 upon and subject to the terms and conditions which the said agreement contained.

14. By the said agreement it was provided, *inter alia,* that as and from the commencement of the financial year of the Company next following the date of the said agreement, viz., 1st October, 1936, and until all moneys advanced under the provisions thereof with interest as therein provided should have been repaid to the bank, the Company should pay to the bank all dividends which it should receive in respect of all the said shares as and when received in reduction of the amount from time to time and for the time being remaining due to the bank in respect of the said moneys advanced and the said interest thereon.

15. The Company acquired the shares specified in the schedule to the said agreement (other than Frank Fattorini's shares which had been previously acquired as above recited in the course of the negotiations which led up to the agreement of 22nd September, 1936) on 23rd September, 1936, and transfers of such shares were executed on that date. Since then the income of the Company which is derived from the dividends on the Company's holding of

shares in the operative companies has been paid over to the bank pursuant to the said agreement of 22nd September, 1936. The purchase price of the shares referred to in the said agreement amounted in the aggregate to £121,221 9*s.* 9*d.* The Company borrowed towards this purchase price from the bank the sum of £103,908 18*s.* 3*d.*, and provided the balance from its own resources.

16. The following further accounts are annexed hereto and form part of this Case(1):—

(i) Copies of the profit and loss account and balance sheet of the Company for the year ended 7th February, 1935, marked " F.1 ".

(ii) Copies of the like accounts of the Company for the period 7th February, 1935, to 30th September, 1936, marked " F.2 ".

(iii) Copies of the like accounts for the Company's financial year ended 30th September, 1937, marked " G ".

(iv) The profit and loss and appropriation account of the Company for the year ended 5th April, 1937, marked " H ".

(v) The profit and loss and appropriation account of the Company for the year ended 5th April, 1938, marked " I ".

17. The " actual income " of the Company for the years of assessment 1936-37 and 1937-38 under consideration (which was attributable entirely to shares in the operative companies) subject to the terms of the agreement of 22nd September, 1936, was as follows:—

| | 1936–37 | 1937–38 |
|---|---|---|
| Income from investments (gross) ... | £6,540 | £34,855 |
| *Less* bank interest paid ... ... | £1,200 | £3,715 |
| | £5,340 | £31,140 |

The Company paid no dividend during the said two years out of the said income.

18. The Special Commissioners in pursuance of Section 21 of the Finance Act, 1922, and Section 14, Sub-section (2), of the Finance Act, 1937, directed that for the purpose of assessment to Sur-tax the total income from all sources of the Company for the years of assessment 1936–37 and 1937–38 respectively be deemed to be the income of the members of the Company and that the amount thereof should be apportioned among the members. The said directions were discharged by the Special Commissioners on appeal by the Company as in paragraph 2 hereof stated.

19. At the re-hearing before the Board oral evidence was given by Mr. Stephen Edwin Brown, solicitor to the Company, as appears from a transcript of the note taken by the official shorthand writer. A copy of the said note is annexed hereto, marked " J ", and forms part of this Case(1).

20. The facts stated in paragraphs 1 to 14 of the statement of facts and grounds upon which the Commissioners of Inland Revenue based their demand for re-hearing, as amplified by the counter-statement of the Company and the addendum thereto, were admitted. The above are annexed hereto, marked " K ", " L " and " M " respectively, and form part of this Case(1).

(1) Not included in the present print.

21. It was contended on behalf of the Company:—

(i) That by reason of the agreement between the Company and the bank dated 22nd September, 1936, the Company was obliged to pay all dividends on the shares in the operative companies received by it during the two years under review and constituting its actual income as aforesaid to the bank in reduction of its indebtedness to the bank.

(ii) That inasmuch as the said dividends were the whole of the Company's "actual income" for the said two years the Company had no income available for distribution to its members for the said two years or either of them.

(iii) That the case was governed by the decision in *Glazed Kid, Ltd.* v. *Commissioners of Inland Revenue,* 15 T.C. 445; and that on the facts of the case Section 31 (1) of the Finance Act, 1927, did not apply.

(iv) That, alternatively, there was no part of the Company's income for the said years or either of them which it was reasonable for the Company to distribute to its members having regard to the current requirements of the Company's business and/or to such other requirements as were necessary or advisable for the maintenance and/or development of that business.

22. It was contended on behalf of the Commissioners:—

(i) That the Company is purely an investment holding company and substantially the whole of its profits (derived from income from investments) should be distributed to its shareholders.

(ii) That prior to the acquisition by the Company of the shares in question the Company's business formerly that of a trading company had become merely the business of investing its then existing capital and it was not therefore necessary or advisable either for the current requirements of the Company or for the maintenance or development of its business to acquire the shares in question or to incur the obligation to the bank under the said agreement of 22nd September, 1936.

(iii) That in the circumstances of this case the contractural obligation entered into with the bank under the agreement of 22nd September, 1936, was not an obligation which was necessary for the current requirements or maintenance or development of the Company so as to preclude directions being made on the Company under Section 21 of the Finance Act, 1922 (as amended), for the years in question.

(iv) That although the Company was under a contractural obligation to pay to the bank the dividends which it received it was under no obligation not to declare dividends and accordingly that the Company could lawfully have distributed by way of dividends the profits which it had earned in the said years and if necessary the Company could lawfully have borrowed the necessary money to enable it to make such distribution.

(v) That the said shares acquired by the Company were the first property (as distinguished from business or undertaking) of a substantial character in fact acquired by the Company and that accordingly the dividends paid to the bank under the said agreement were sums expended or applied in repayment of a debt incurred in or towards

payment for such property within Section 31 (1) (*a*) (ii) of the Finance Act, 1927, or were sums expended or applied in meeting an obligation of the Company in respect of the acquisition of the said property within Section 31 (1) (*a*) (iii) of the Finance Act, 1927.

(vi) That for the years of assessment 1936–37 and 1937–38 under consideration the Company had not in the circumstances distributed a reasonable part of its actual income from all sources within the meaning of Section 21 of the Finance Act, 1922 (as amended), and the said directions should be restored.

23. We, the members of the Board, sitting to re-hear the appeal, hold as a matter of construction of the contract with Martins Bank that it would not have been a breach of contract for the Company to distribute a dividend and we found as a fact that if we were wrong on this point and a distribution of a dividend would have been a breach of contract it was not reasonable for the Company to make such a contract. We hold that the case of *Glazed Kid, Ltd.* v. *Commissioners of Inland Revenue* (15 T.C. 445) was distinguishable as it was assumed in the judgment in that case that the distribution of a dividend could only have been made if moneys payable to the bank had been retained, a course which would have been restrained by injunction ; and there appeared to be no argument that the contract was not a reasonable contract.

24. We considered that, as the Company was an investment company which, after 24th August, 1936, held investments producing revenue for which the Company had paid £18,000, there was a *prima facie* case that the reasonable course was that the Company should so manage its affairs as to provide for distribution of dividend; and that the Company had not displaced such *prima facie* case by evidence that this could not have been done without jeopardising the interests of the Company, or without making it impossible to acquire the shares which it desired to buy.

25. We found as a fact that the Company had not within a reasonable time distributed in the manner referred to in Section 21 of the Finance Act, 1922, a reasonable part of its income for either of the periods in question.

26. We also found (in case the Court should think it material) that the shares purchased with money borrowed from Martins Bank were not the first property of a substantial character acquired by the Company.

27. We, the Board, therefore determined that the determination of the Special Commissioners on 22nd November, 1938, upon the appeal to them should be reversed and the directions of the Special Commissioners given under Section 21 of the Finance Act, 1922, restored.

28. Immediately upon the determination of this appeal by us, dissatisfaction was expressed on behalf of the Company with the determination as being erroneous in point of law, and in due course the Company required us to state a Case for the opinion of the High Court of Justice pursuant to the above-mentioned Act which Case we have stated and do sign accordingly.

29. The questions for the opinion of the Court are:—

(1) Whether our conclusions of law as set forth in paragraph 23 were correct.

(2) Whether there was evidence to support our finding of fact as set forth in paragraph 25.

(3) Whether the matters set forth in paragraph 24 are such as to shew that we misdirected ourselves as to the onus of proof in a case where it is admitted that an investment company with a substantial income has not distributed any part of it.

F. E. BRAY
ARTHUR D. DEAN
C. HEWETSON NELSON
R. FELL-CLARK
C. D. MORTON

12th September, 1939.

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The case came before Macnaghten, J., in the King's Bench Division on 3rd and 6th May, 1940, when judgment was reserved. On 9th May, 1940, judgment was given against the Crown, with costs.

Mr. Terence Donovan appeared as Counsel for the Company, and the Attorney-General (Sir Donald Somervell, K.C.) and Mr. Reginald P. Hills for the Crown.

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JUDGMENT

**Macnaghten, J.**—This is a Case stated for the opinion of the High Court by the Board of Referees under Paragraph 2 of the First Schedule to the Finance Act, 1922.

The Commissioners for the Special Purposes of Income Tax made directions under Section 21 of the Finance Act, 1922, that for the purposes of assessment to Sur-tax the actual income from all sources of a company called Thomas Fattorini (Lancashire), Ltd., for the years of assessment 1936–37 and 1937–38 respectively, should be deemed to be the income of the members and the amount thereof apportioned among them.

The Company, Thomas Fattorini (Lancashire), Ltd., being aggrieved by those directions appealed to the Special Commissioners, who discharged the directions. The Commissioners of Inland Revenue being dissatisfied with that decision required the appeal to be re-heard by the Board of Referees, and the Board of Referees decided that the directions should be restored. The Company being dissatisfied with that decision required the Board of Referees to state a Case for the opinion of the Court, and so the case comes here for decision.

Thomas Fattorini (Lancashire), Ltd., was registered as a company limited by shares under the Companies Acts on 9th April, 1919. It was formed with the object, *inter alia*, of acquiring the business of a jeweller theretofore carried on by Mr. Thomas Fattorini at Bolton in Lancashire, and on 1st June, 1919, the Company acquired that business in that town.

Mr. Thomas Fattorini died on 9th June, 1934, leaving two sons, Frank and Wilfred, and three daughters. At the time of his death Thomas Fattorini was the principal shareholder in Thomas Fattorini (Lancashire), Ltd.; he was also the principal shareholder in three other companies, viz.:—(1) Thomas Fattorini (Skipton), Ltd., which had been registered on 16th April, 1919, and carried on the business of jewellers and also a mail order business; (2) Thomas Fattorini (Birmingham), Ltd., which had been registered on 24th February, 1919; (3) H. Pearson, Ltd., which had been registered on 23rd March, 1915. The last-named company had carried on a cycle business, but after 1924 it had given up the cycle business and had taken to a mail order business. These three companies are called in the Case the " operative " companies ".

**(Macnaghten, J.)**

Under the provisions of Mr. Thomas Fattorini's will his sons were given options to acquire his shares in the Appellant Company, but Frank did not exercise the option, and Wilfred bought all his father's shares in the Company. The result was that by the autumn of 1936, Mr. Wilfred Fattorini and his wife, Mrs. Wilfred Fattorini, were the only shareholders in the Company.

The Appellant Company had in fact ceased to carry on business in 1928. From 1928 until 1936 it had no business at all, but it had some money, and that money it lent at interest to one or other of the operative companies.

The position in the autumn of 1936 was this: Mr. Wilfred Fattorini and his wife held all the shares in the Appellant Company. Mr. Wilfred Fattorini himself held a number of shares in the operative companies, and most of the other shares in those companies were held by Mr. Frank Fattorini and the executors of their father.

In 1936 Mr. Wilfred Fattorini was minded to acquire all the shares which his brother and his father's executors held in the operative companies, and he was minded to acquire them by means of the Appellant Company. Accordingly the resources of the Company which by that time amounted to some £18,000 were, in August of that year, employed in buying all Mr. Frank Fattorini's shares in the operative companies. In order to complete the arrangement it was necessary for the Company to buy the shares which belonged to Mr. Wilfred Fattorini and the shares that belonged to the executors of the father, Thomas Fattorini. The shares were apparently of considerable value. £18,000 had been sufficient to buy the shares belonging to his brother Frank, but over £100,000 was required to enable the Company to buy the shares belonging to the executors and to himself personally. It was, therefore, necessary for the Company, if they were to effect the purchase, to borrow the money required. Martins Bank, Ltd. were willing to lend up to £108,000. Accordingly by an agreement made on 22nd September, 1936, between Thomas Fattorini (Lancashire), Ltd., the Appellant Company, of the one part and Martins Bank, Ltd., of the other part, it was recited that the Company was desirous of purchasing the shares specified in the first column of the schedule to the agreement, that the moneys at present at the disposal of the Company were insufficient to enable it to complete the purchase of those shares, and that it accordingly applied to the bank for an advance of the balance of the moneys required, and the bank agreed to advance the Company the balance of such moneys not exceeding £108,000 upon the terms contained in the agreement. They were not required to advance the full sum of £108,000, £103,000 being sufficient for the purpose. By some mistake the shares which the Company bought from Frank Fattorini in the previous month of August were included in the schedule to the agreement as being shares which the Company was proposing to buy. It had in fact by 22nd September, 1936, already acquired those shares.

The terms upon which Martins Bank were willing to advance the money under this agreement were that the share certificates in respect of all the shares specified in the schedule should be deposited with the bank together with blank transfers and powers of attorney to complete the same to secure the repayment on demand to the bank of the principal moneys advanced under the agreement, and the interest thereon with half-yearly rests. The Company was required to execute a letter of deposit in such a form as the bank should require, giving the bank an immediate power of sale and such other powers as they should require and also to hand to the bank all such authorities and other documents and do all such acts and things as the bank should require to ensure registration at any time at the option of the bank or their nominees

**(Macnaghten, J.)**

as holders of the shares, that is, as holders of the shares of the operative companies. They required also the personal guarantee of Mr. Wilfred Fattorini. Further it was provided by paragraph 5 of the agreement: " As " from the commencement of the financial year of the Company next following " the date hereof and until all moneys advanced under the provisions of this " Agreement with interest thereon as aforesaid shall have been repaid to the " Bank the Company shall pay to the Bank all dividends which it shall receive " in respect of the said Shares specified in the Schedule hereto as and when " received in reduction of the amount from time to time and for the time being " remaining due to the Bank of the said moneys advanced and the said " interest thereon." . . . ." 7. The interest payable by the Company to the " Bank on the balance of moneys from time to time due from the Company " to the Bank under the provisions of this Agreement shall be at the rate of " One per cent. over Bank rate for the time being with a minimum of Four " and a quarter per cent. per annum." Then the Company appointed the bank to be its attorney " with full power in the name of the Company or in " their own names on behalf of the Company to execute and do all such " assurances and things which may be necessary or proper in order to vest " in the Bank or their nominees the full benefit of any security from time " to time held by the Bank " and in particular to execute transfers of any shares the certificates for which shall from time to time be deposited with the bank in favour of the bank.

The result of the acquisition by the Appellant Company of the shares in the operative companies was that the actual income of the Company for the year 1936–37 was £5,340, and for the year 1937–38, £31,140. The Board of Referees have restored the directions given by the Special Commissioners under Section 21 of the Finance Act of 1922. That Section applies to companies under the control of not more than five persons, and it obviously applies to this Company where the only shareholders were Mr. Wilfred Fattorini and his wife. The relevant words of the Section are: " Where " it appears to the Special Commissioners that any company to which this " section applies has not, within a reasonable time after the end of any year " or other period ending on any date subsequent to the fifth day of April, " nineteen hundred and twenty-two, for which accounts have been made up, " distributed to its members in such manner as to render the amount distri- " buted liable to be included in the statements to be made by the members of " the company of their total income for the purposes of super-tax, a reasonable " part of its actual income from all sources for the said year or other period, " the Commissioners may, by notice in writing to the company, direct that " for purposes of assessment to super-tax, the said income of the company " shall, for the year or other period specified in the notice, be deemed to " be the income of the members, and the amount thereof shall be apportioned " among the members ". By Paragraph 6 of the First Schedule to the Act it is directed that the actual income from all sources is to be computed in the same manner as it is for the purposes of Income Tax, except that instead of being the income of the preceding year the actual income is to be the income of the year to which the directions relate.

As the Attorney-General pointed out, if Mr. and Mrs. Wilfred Fattorini instead of making use of the Appellant Company for carrying out the purchase of the shares in the operative companies had carried out the transactions in their own name, there is no doubt that the dividends that they would then themselves have received from the operative companies would have to be taken into account for the purposes of assessment to Sur-tax. But that fact is not material to the issue before me. In the years in question the Appellant Company distributed no dividends.

**(Macnaghten, J.)**

The question is whether that agreement with Martins Bank precludes the Commissioners from giving the directions which they would otherwise plainly have been entitled to give.

The Board of Referees in restoring the directions of the Special Commissioners have given their reasons. They say they hold as a matter of construction of the contract of 22nd September, 1936, that it would not have been a breach of contract for the Company to distribute a dividend. The learned Attorney-General cited the case of *Montague Burton,* 20 T.C. 48, where Romer, L.J., pointed out that the fact that a company has used its income for the purpose of buying a capital asset does not prevent a company from distributing a dividend(1). That is unquestionably so. A company limited by shares must not pay a dividend out of capital but if it applies its income or a part of it for the purchase of a capital asset that does not preclude it, if it has the resources available for the purpose, from distributing a dividend to its shareholders. The decision of the Board that as a matter of construction the agreement of 22nd September, 1936, does not forbid the Company to pay a dividend is an academic question in view of the fact that the agreement is so drawn as to preclude the Company from doing so. The Case states that the income derived from these shares in the operative companies was the only source of income that the Appellant Company had. The Company was bound to pay to the bank any dividends that the operative companies paid and the bank had taken precautions against any breach of that obligation. The bank of its own motion could complete the transfers of the shares in the operative companies and put itself upon the register of those companies, and so have the dividends paid to itself. Since the Company had no assets except these shares it would have been impossible for the Company to obtain from any source money with which to pay any dividend to its shareholders. The Board of Referees go on to say: "and we found as a fact that if we were wrong on this point and a distribution "of a dividend would have been a breach of contract it was not reasonable "for the Company to make such a contract." It was pointed out by Mr. Donovan, who argued the case for the Appellant Company, if I may say so, most ably and most lucidly, that it was no affair of the Board of Referees to form any opinion as to whether the contract of 22nd September, 1936, was reasonable or unreasonable; and, moreover, they do not appear to have had any evidence on which to form such an opinion; the Board do not state whether they regard it as unreasonable from the point of view of the bank or unreasonable from the point of view of the Company. The agreement no doubt is peculiar in this respect that one would have thought that the bank being willing to venture so much as £103,000 on the security of these shares and the personal guarantee of Mr. Wilfred Fattorini, would not have thought it necessary to insist on receiving all the dividends of the operative companies after the loan had been substantially reduced. Whether it was the bank that insisted on the insertion of that provision or whether it was Mr. Wilfred Fattorini who offered it perhaps with a view to pecuniary advantages that would accrue to himself thereby does not matter. The contract cannot be impeached in any way; it is binding on the Company; and even if it was not reasonable for the Company to make such a contract that fact could have no bearing as it seems to me, on the matter before me.

The Board of Referees go on to say that the case of *Glazed Kid, Ltd.* v. *Commissioners of Inland Revenue,* 15 T.C. 445, is distinguishable from this case. I am unable to see any distinction at all. If there is a distinction

(1) Montague Burton, Ltd. (in liquidation) *v.* Commissioners of Inland Revenue, 20 T.C. 48, at pp. 70/73.

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between the two cases I think in this case the obligations which prevent a company from paying any dividends are if anything stronger than they were in the *Glazed Kid* case(1). Otherwise it seems to me the two cases are on all fours. Even if I were of the opinion—which I am not—that the contention of the Crown was well-founded, I should be bound by the decision of Rowlatt, J., to allow this appeal, on the ground that on the facts stated in the Case the decision of the Special Commissioners discharging the directions which have been given under Section 21 of the Finance Act, 1922, was right and that there was no evidence on which the decision could be reversed.

In my opinion, therefore, this appeal must be allowed and with costs.

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The Crown having appealed against the decision in the King's Bench Division, the case came before the Court of Appeal (Scott, Clauson and Goddard, L.JJ.) on 4th, 5th and 8th July, 1940, when judgment was reserved. On 2nd August, 1940, judgment was given unanimously in favour of the Crown, with costs, reversing the decision of the Court below.

The Attorney-General (Sir Donald Somervell, K.C.) and Mr. Reginald P. Hills appeared as Counsel for the Crown, and Mr. J. Millard Tucker, K.C., and Mr. Terence Donovan for the Company.

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JUDGMENT

**Scott, L.J.**—This appeal raises a question of the application of Section 21 of the Finance Act, 1922, to the Respondent Company, which we shall call " the Company ". The Special Commissioners, acting under that Section, by notice in writing to the Company, directed that, for purposes of assessment to Sur-tax, the income of the Company for the years 1936–37 and 1937–38 should be deemed to be the income of the members. The Company appealed to the Special Commissioners acting in their judicial capacity, who discharged the direction. The Commissioners of Inland Revenue then appealed to the Board of Referees, who allowed the appeal and stated a Case for the High Court. Macnaghten, J., reversed that decision and restored the decision of the Special Commissioners discharging the original direction. The present appeal is from his decision. The facts found by the Board of Referees can be stated shortly.

The Company was incorporated in 1919 as a private company with wide powers, *inter alia*, to take over a profitable business in jewellery over the counter and by mail orders conducted by Thomas Fattorini whose name the Company bears. This it conducted till 1928, when it discontinued the former part of the business and sold the latter to a company called Thomas Fattorini (Skipton), Ltd., for £14,000. This company was one of three private companies which the Special Commissioners call " the operative companies ", in contradistinction to the Company which thus ceased to operate. It, too, dated from 1919, and carried on the same two types of business as the Company had conducted. The second operative company was Thomas Fattorini (Birmingham), Ltd., also incorporated in 1919. It carried on at Birmingham the same two types of business. The third was called H. Pearson, Ltd., incorporated in 1915; its business was originally that of cycle dealers, but in 1924, when Mr. Thomas Fattorini acquired its share control, the cycle business was dropped and thenceforth it carried on a mail order business at Manchester.

Thomas Fattorini died in 1934, then owning 10,100 ordinary shares in the Company and, apparently, practically all the shares in the three operative

(1) 15 T.C. 445.

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companies. He left two sons, Frank and Wilfred, and by his will gave them an option to buy his shares in the Company. In April, 1936, the Company agreed to buy all Frank's shares in the three operative companies for £18,229, paid for them out of its own resources, and became the registered holder in August, 1936. As Frank did not want to buy his father's shares in the Company, Wilfred did so and, on 17th September, 1936, was duly registered as the holder of the 10,100 shares. On 23rd September, 1936, the Company acquired all the remaining shares in the three operative companies then held by either the executors of Thomas Fattorini, or Wilfred, for £121,221. In order to provide the necessary money it had entered into an agreement with Martins Bank by which that bank agreed to advance up to a maximum of £108,000 on deposit by way of charge of the shares then to be bought and also the shares previously bought from Frank, and in consideration of a covenant by the Company to pay to the bank all the dividends as and when received by the Company, not only on the shares then to be purchased, but also on the £18,229 worth of shares already bought from Frank and paid for by the Company, and of a personal guarantee of the overdraft by Wilfred. The mortgage of the shares necessarily carried with it a charge upon the dividends; and we are not satisfied that the covenant to pay the dividends gave the bank any further right than they necessarily obtained as mortgagees. The amount in fact so borrowed from the bank was £103,908, or £17,313 less than the purchase price.

It was contended for the Company that its " actual income " (within the meaning of Section 21) for the two years in question consisted solely of the dividends receivable on the whole of the shares in the three operative companies; that, in the circumstances, the actual income and the dividends in fact meant the same thing, so that apparently the Company had contracted itself out of the whole of its " actual income ". But that statement of the position is only a half-truth. The dividends, no doubt, constituted the Company's gross receipts, but not its " income " for Income Tax purposes; the interest paid to the bank, for instance, had to be deducted from the gross receipts. But if by the contention it was intended to base an inference of fact that the Company possessed no assets out of which it could raise money, to take the place of income which it had found it convenient to devote to a capital purpose, with a view to a declaration of dividend, the facts do not support the inference.

The bank had advanced the £103,908, but the Company had found the balance of £17,313, and also the whole price of £18,229 paid for the shares previously bought from Frank Fattorini, the bank thus providing roughly three-quarters and the Company, out of its own resources, one-quarter of the cost of the totality of shares charged to the bank. The Company did not pay or declare any dividend of its own in respect of either of the years in question, and has contended throughout that, as it had agreed to pay all the dividends to the bank, and those dividends made up its whole income, it had no income to distribute; and it relied on the decision of Rowlatt, J., in *Glazed Kid, Ltd.* v. *Commissioners of Inland Revenue,* 15 T.C. 445. The Commissioners contended that the Company, having become a mere holding company and having no other business, should distribute its whole income; that it had no requirements or needs falling within the proviso to Sub-section (1) of Section 21; that the fact that it had used the dividends, as and when received, to pay into the bank, did not, in the circumstances of the case, prevent it from declaring a dividend; and finally, that it had not distributed a reasonable part of its income. The findings of the Board of Referees were as follows: Paragraph 23: " We, the members of the Board, sitting to re-hear

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" the appeal, hold as a matter of construction of the contract with Martins " Bank that it would not have been a breach of contract for the Company to " distribute a dividend and we found as a fact that if we were wrong on this " point and a distribution of dividend would have been a breach of contract " it was not reasonable for the Company to make such a contract. We hold that " the case of *Glazed Kid, Ltd.* v. *Commissioners of Inland Revenue* (15 T.C. 445) " was distinguishable, as it was assumed in the judgment in that case that the " distribution of a dividend could only have been made if moneys payable " to the bank had been retained, a course which would have been restrained " by injunction; and there appeared to be no argument that the contract " was not a reasonable contract." Paragraph 24: " We considered that, " as the Company was an investment company which, after 24th August, " 1936, held investments producing revenue for which the Company had paid " £18,000, there was a *prima facie* case that the reasonable course was that " the Company should so manage its affairs as to provide for distribution of " dividend; and that the Company had not displaced such *prima facie* case " by evidence that this could not have been done without jeopardising the " interests of the Company, or without making it impossible to acquire the " shares which it desired to buy." Paragraph 25: " We found as a fact " that the Company had not within a reasonable time distributed in the " manner referred to in Section 21 of the Finance Act, 1922, a reasonable " part of its income for either of the periods in question."

The finding in the first part of paragraph 23 that it was " not reasonable " to make such a contract " is, in our view, an irrelevant observation, and constitutes no valid ground for distinguishing the *Glazed Kid* case. Section 21 does not control the manner in which the Company shall conduct its business. It is paragraphs 24 and 25 which contain the crucial findings of fact. In our opinion, it is impossible to say that there was no evidence to support them—particularly paragraph 25—and that is sufficient for allowing the appeal.

The audited accounts of the Company, marked F.1, F.2 and G, are annexed to and form part of this Case(1), and the position they disclose throws material light on this issue. The Company's year used to run to the 7th February, and F.1 is the account for the year ending February, 1935. F.2 is for a longer period, namely, from February, 1935, to 30th September, 1936, Wilfred Fattorini having, no doubt on his acquisition of control, changed the date to suit his plan to meet Section 21 of the Finance Act, 1922. It shows £1,965 profit carried forward from F.1; and that the issued capital was, during that period, raised from 10,500 to 15,000 £1 ordinary shares fully paid, and from 1,500 to 1,765 £1 preference shares fully paid, so that the Company received, presumably, £4,500 plus £265, in cash; it also shows the then bank overdraft at £103,994. G. shows for the changed company year ending 30th September, 1937, £1,675 profit carried forward from F.2, and a net balance of profit, after deducting bank interest, etc., from dividends and preference interest received on certain shares of £25,227; and investments, consisting of the shares of the three operative companies as in F.2 at £122,435; and it shows an important change—the bank overdraft reduced to £80,442.

It is to be observed that the 44,980 ordinaries in Thomas Fattorini (Skipton), Ltd., were bought at a premium of about 40 per cent., the 24,980 ordinaries in H. Pearson, Ltd., at a premium of about 90 per cent., and the 13,480 ordinaries in Thomas Fattorini, Ltd., at a discount of about 25 per cent. They were businesses of many years' standing, and apparently prosperous commercial concerns; if so, further money could easily be raised on their shares. It seems to us obvious that in the absence of any evidence proving inability on the part of the Company to borrow enough either to release some

(1) Not included in the present print.

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of the dividend income, or (those specific receipts of cash having been put out of reach) to obtain enough money by other means to distribute a reasonable dividend, the finding in paragraph 25 of the Case must stand; it cannot possibly be said that there was no evidence to support it. The onus of proof was on the Company, and they made no attempt to prove any over-valuation of the shares, either on the purchase or as appearing in the two balance sheets, or that the operative companies were likely to make losses, or even were not prospering; nor did they make any other attempt to show that they could not declare a dividend. They left the facts alone, but relied before the Board of Referees on a rule of law which, they contended, had been laid down by Rowlatt, J., in the *Glazed Kid Company's* case(1). It was not unnatural for the Company to rely in argument on that case, as the whole plan in the present case for protecting its two shareholders from Sur-tax was in form a replica of the plan in that case. Rowlatt, J., there seems to have held that the *de facto* appropriation of the specific dividends to the performance of the bank agreement, pursuant to a legal obligation, used up " the " actual income " of the company for good and all and made it impossible, in law, to hold that thereafter the company had any income left to distribute.

Macnaghten, J., in the present case, agreed with and followed the view of Rowlatt, J., adding that in any event he would be bound by that decision; but certain reasons he gave were, we think, wrong, even if the *Glazed Kid* decision bound him. He says in his penultimate paragraph(2): " The decision " of the Board that as a matter of construction the agreement of 22nd " September, 1936, does not forbid the Company to pay a dividend is an " academic question in view of the fact that the agreement is so drawn as " to preclude the Company from doing so. The Case states that the income " derived from these shares in the operative companies was the only source " of income that the Appellant Company had . . . . Since the Company had " no assets except these shares it would have been impossible for the Company " to obtain from any source money with which to pay any dividend to " its shareholders."

Our reasons are these. The judgment of Rowlatt, J., attached a meaning to the expression " actual income " with which we disagree. He treated it as connoting the receipts side only of the income account. He assumed that if the actual receipts in the statutory year mentioned in Section 21 had been assigned or hypothecated under a binding contract, the Company's " actual income " had passed out of its control and, therefore, ceased to be available for distribution. This, in our opinion, is an error. The true meaning of the phrase, we think, is indicated by the context, and by certain provisions of the Act of 1918. " Income tax . . . is a tax on income . . . " whatever may be the standard by which the income is measured ", per Lord Macnaghten in *London County Council* v. *Attorney-General*(3), [1901] A.C. 26, at pages 35/6; and the phrase " profits and gains " in Income Tax legislation is, at any rate under Schedule D, no more than a synonym for " income ". For purposes of assessment the income of an anterior period was and is " deemed to be the income " of the person charged for the year of assessment; he is charged on a conventional or putative, and not the actual income; till 1927 it was an average of three years; since then it has been of the preceding year. In the case of Super-tax, also, the " total income " was to be ascertained on the previous year's basis—see Section 5(1) of the Income Tax Act, 1918; and, where tax had been deducted at the source, the income of the previous year before deduction was to be " deemed to be income of " the year in which it is receivable "—see Section 5(3)(*c*). Finally, Rule 8

(1) 15 T.C. 445. (2) *See* page 338 *ante*. (3) 4 T.C. 265, at pp. 293/4.

**(Scott, L.J.)**

of the Rules applicable to Cases I and II of Schedule D, reproducing Section 24 of the Finance Act, 1907, but repealed by the Finance Act, 1926, provided that where " *the actual* profits or gains ", i.e., the income, " . . . . in the year " of assessment fall short of the profits or gains as computed in accordance " with this Act, he shall be entitled to be charged on the *actual* amount of " the profits or gains so arising, instead of on the amount of the profits " or gains so computed ". That Rule, in the Act of 1918, we think, supplies the key to the meaning of the word " actual " in Section 21 of the Act of 1922, which called for interpretation in the *Glazed Kid* case(1) and calls for it in the present case. It was inserted to make it clear that it is not the conventional, but the *de facto* income of the year in question which is the subject to the duty to distribute. The epithet " actual " in such a sense is illustrated in Income Tax law by the Finance Act, 1907, Section 24, Sub-sections (2) and (3), where the successor to a continuing business and his predecessor who ceases to carry it on, is taxed on his " actual income " in the two broken periods of the year. The fact that the word is used in that sense in Income Tax legislation still in force in 1922 seems to us conclusive.

It is not true to say, as the learned Judge below said, that the bank agreement precluded the Company from paying a dividend. As I have pointed out, even the fact that the charged shares were the Company's only asset would not have prevented them. If the learned Judge regarded those two considerations as obstacles not in law but in fact, that question was for the Board of Referees, not for him, and his view is inconsistent with the finding in paragraph 25 of the Case; if in law, we do not agree with him. There is nothing in law to prevent a company using an income receipt as cash in its hands to discharge a capital liability; and then, after the close of its financial year, using a general credit balance, or even borrowing, to restore the profit and loss position for the purpose of dividend. Indeed we think that the judgment of Romer, L.J. (as he then was), in *Montague Burton, Ltd.* (*in liquidation*) v. *Commissioners of Inland Revenue,* 20 T.C. 48, at pages 70 and 71, expresses this view: " The case of the Appellant Company is this: they " say that during the financial year which is in question in the case they spent " out of income a sum largely in excess of the net profits that they earned by " their trading during that year, and that therefore the Commissioners had no " right to give any such direction as they purported to give under Section 21, " Sub-section (1), in relation to that income. In other words, the income " having been spent upon current requirements of the Company's business— " requirements that were necessary or advisable for the maintenance and " development of that business—it is taken for ever out of the operation of " the Sub-section, and no direction could thenceforward be given by the " Commissioners in relation to it. I disagree with the premises, and, if the " premises could be accepted, I disagree with the result that is said to flow " from them. . . . . At most, it can be said that the money has been " temporarily taken out of revenue, and it is for the directors to determine, " at the time when they have to consider the question of what they will do " with their profits, whether the sum so temporarily taken out of revenue " is to be permanently allocated to revenue so as to capitalize the payments— " that part of the revenue—or is to be taken out of capital assets." Lord Hailsham, L.C., and Lord Russell of Killowen, at page 77, both expressed approval of the judgment of Romer, L.J.

There are certain differences between the present case and the *Glazed Kid Company's* case(1), but we are not satisfied that they are sufficient to leave

(1) 15 T.C. 445.

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that decision uncriticised; and so far as it may be inconsistent with the principles we have expressed, we cannot agree with it.

The judgment of the Court, therefore, is that the appeal must be allowed with costs here and below, and the second question answered in the affirmative. It is unnecessary to answer the other two questions.

**Clauson, L.J.**—I agree, and I have nothing to add.

**Goddard, L.J.**—I agree.

**Mr. Tucker.**—My Lords, might I make an application for leave to appeal, and may I just put shortly the three points for your Lordships to consider?

**Scott, L.J.**—We think there ought to be leave to appeal, but we should like to hear what Mr. Hills has to say on the question of the costs of going to the House of Lords.

**Mr. Tucker.**—May I say this, before my learned friend begins? So far, your Lordships' Court, the Court of Appeal, have never made any condition against a taxpayer.

**Scott, L.J.**—No.

**Mr. Hills.**—I am in your Lordships' hands in this matter. If your Lordships think this is a proper case for an appeal to the House of Lords, I do not think I ought to resist it, in view of the decision of the Court below.

**Scott, L.J.**—Yes, we do.

**Mr. Tucker.**—I am much obliged, my Lord.

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An appeal having been entered against the decision in the Court of Appeal, the case came before the House of Lords (Viscount Simon, L.C., and Lords Atkin, Macmillan, Wright and Porter) on 10th, 12th, 13th and 16th February, 1942, when judgment was reserved. On 27th April, 1942, judgment was given unanimously against the Crown, with costs, reversing the decision of the Court below.

Mr. Terence Donovan appeared as Counsel for the Company, and the Solicitor-General (Sir William Jowitt, K.C.) and Mr. Reginald P. Hills for the Crown.

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JUDGMENT

**Viscount Simon, L.C.**—My Lords, this appeal arises out of a Case Stated for the opinion of the High Court by the Board of Referees under Paragraph 2 of the First Schedule of the Finance Act, 1922. The Appellant is a company "under the control of not more than five persons" to which Section 21 of that Finance Act applies. The Company is purely an investment company and before entering into the transactions next to be stated held investments for which the Company had paid over £18,000, and which were producing revenue.

Those controlling the Company were Mr. Wilfred Fattorini and his wife; they were, as I understand, the only shareholders and were the directors of the Company. It was desired to increase the investments held by the Company by acquiring certain large holdings of shares in other companies (which have been called "the operative companies" to distinguish them from the investment Company), but the Appellant Company had no sufficient resources of its own by means of which to make the purchase. Accordingly, it approached Martins Bank, Ltd., and on 22nd September, 1936, an agreement was made under which the bank undertook to advance a sum not exceeding £108,000 at a stipulated rate of interest. With this advance, supplemented by its own

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cash, the Company acquired the shares of the operative companies at a price of £121,221. The bank's loan was secured by a deposit of all the shares including the investments already owned by the Company, and the Company bound itself to pay to the bank, until the loan was completely discharged, all dividends which it received in respect of any of its investments. These dividends were the Company's sole source of income.

The investments in the operative companies' shares brought in an excellent return; in the financial year 1936–37 the income from all investments was £6,540, and in the financial year 1937–38 no less than £34,855. These amounts were paid over to the bank in accordance with the agreement, with the result that the bank loan was proportionately reduced.

The Appellant Company declared no dividend during or in respect of the two years above referred to. The Special Commissioners, acting under the powers conferred upon them by Section 21 of the Finance Act, 1922, as amended, directed that, for the purpose of assessment to Sur-tax, the total income from all sources of the Company for the years of assessment 1936–37 and 1937–38 respectively (see Section 14 (2) of Finance Act, 1937) should be deemed to be the income of the members of the Company, and that the amount should be apportioned among them. The Company appealed to the Special Commissioners in their judicial capacity against such direction and the Special Commissioners allowed the appeal and discharged the direction for both years. The Respondents required the appeal to be re-heard by the Board of Referees which, subject to the Case Stated, reversed the decision of the Special Commissioners and restored the direction. The Stated Case came before Macnaghten, J., who delivered judgment reversing the determination of the Board of Referees and restoring that of the Special Commissioners. From this decision the Respondents appealed to the Court of Appeal (Scott, Clauson and Goddard, L.JJ.) which reversed the decision of Macnaghten, J., and restored the determination of the Board of Referees. There has thus been a constant alternation of view in the course of this litigation, each tribunal in turn reversing the decision brought to it on appeal.

Counsel for the Appellant Company, in his excellent argument, placed before the House the statutory history of successive efforts made by the Legislature to prevent the avoidance of Super-tax, or of its successor Sur-tax, by using the cloak afforded by company law. Since the tax is charged only in respect of the income of an individual, its incidence might be avoided by transferring to a company controlled by such individual, in return for shares, the source of such income and by securing that, instead of any dividends being declared, the profits made by the company should be accumulated and ultimately distributed in a capital form as the results of voluntary liquidation or by creating bonus shares (*Commissioners of Inland Revenue* v. *Blott*, [1921] 2 A.C. 171; 8 T.C. 101) or otherwise. Accordingly, by Section 21 of the Finance Act, 1922, it was enacted: "With a view to preventing the avoidance of the payment of super-" tax through the withholding from distribution of income of a company which " would otherwise be distributed, it is hereby enacted as follows— (1) Where " it appears to the Special Commissioners that any company to which this " section applies has not, within a reasonable time after the end of any year " or other period ending on any date subsequent to the fifth day of April, " nineteen hundred and twenty-two, for which accounts have been made up, " distributed to its members in such manner as to render the amount dis-" tributed liable to be included in the statements to be made by the members " of the company of their total income for the purposes of super-tax, " a reasonable part of its actual income from all sources for the said year or " other period, the Commissioners may, by notice in writing to the company,

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" direct that for purposes of assessment to super-tax, the said income of the " company shall, for the year or other period specified in the notice, be deemed " to be the income of the members, and the amount thereof shall be apportioned " among the members. . . . Provided that, in determining whether any " company has or has not distributed a reasonable part of its income as aforesaid, " the Commissioners shall have regard not only to the current requirements of " the company's business but also to such other requirements as may be " necessary or advisable for the maintenance and development of that " business."

The First Schedule of the Act of 1922 provides that " actual income from all " sources " is to be computed by reference to the income for the year in question, and not to that of a past period. In order to complete the statutory scheme as it applied to the years 1936–37 and 1937–38, it is necessary to add a reference to the Finance Act, 1927, Section 31, and the Finance Act, 1936, Section 20. These later enactments, however, do not affect the present case, since the shares of the operative companies purchased as the result of the agreement of 22nd September, 1936, were not the first property of a substantial character acquired by the investment Company, and moreover the loan was from a bank.

Mr. Donovan pointed out that the Legislature has now, in the case of some investment companies, made it more difficult to escape the burden of Sur-tax (see Finance Act, 1939, Section 14 (1) ), but this is outside the period within which the present dispute falls, and it must not be assumed as a matter of statutory construction that earlier provisions have a particular meaning because if so interpreted the need for the later enactment is elucidated.

The paragraphs of the Stated Case which raise the matters now to be decided are the following: " **23.** We, the members of the Board, sitting to " re-hear the appeal, hold as a matter of construction of the contract with " Martins Bank that it would not have been a breach of contract for the " Company to distribute a dividend and we found as a fact that if we were " wrong on this point and a distribution of a dividend would have been a " breach of contract it was not reasonable for the Company to make such a " contract. We hold that the case of *Glazed Kid, Ltd.* v. *Commissioners of* " *Inland Revenue* (15 T.C. 445) was distinguishable, as it was assumed in the " judgment in that case that the distribution of a dividend could only have " been made if moneys payable to the bank had been retained, a course which " would have been restrained by injunction; and there appeared to be no " argument that the contract was not a reasonable contract. 24. We con- " sidered that, as the Company was an investment company which, after " 24th August, 1936, held investments producing revenue for which the Company " had paid £18,000, there was a *prima facie* case that the reasonable course " was that the Company should so manage its affairs as to provide for dis- " tribution of dividend; and that the Company had not displaced such *prima* " *facie* case by evidence that this could not have been done without jeopardising " the interests of the Company, or without making it impossible to acquire the " shares which it desired to buy. 25. We found as a fact that the Company " had not within a reasonable time distributed in the manner referred to in " Section 21 of the Finance Act, 1922, a reasonable part of its income for either " of the periods in question." And the questions for the opinion of the Court are thus stated: " (1) Whether our conclusions of law as set " forth in paragraph 23 were correct. (2) Whether there was evidence " to support our finding of fact as set forth in paragraph 25. (3) Whether " the matters set forth in paragraph 24 are such as to shew that we " misdirected ourselves as to the onus of proof in a case where it is admitted " that an investment company with a substantial income has not distributed " any part of it."

**(Viscount Simon, L.C.)**

As regards paragraph 23, I agree that the contract with the bank did not bind the Company not to distribute a dividend, and inasmuch as the Company made profits in each of the years in question, the fact that it used the dividends it received (as it was bound to do) in reducing the charge on the shares, did not make it unlawful to distribute a dividend. There is nothing in law to prevent a company using an income receipt as cash in its hands to discharge a capital liability or to purchase a capital asset, and then, after the close of its financial year, paying a dividend out of other cash, or borrowing for the purpose, to the extent of the credit balance standing on profit and loss account. This was very clearly explained by my noble and learned friend Lord Romer, when sitting in the Court of Appeal in *Montague Burton, Ltd.* v. *Commissioners of Inland Revenue*, 152 L.T. 8, on page 16; 20 T.C. 48, at page 70, and his view was affirmed on appeal to this House, particularly in the speeches of Lord Hailsham, L.C., and of Lord Russell of Killowen, 154 L.T. 355, at pages 359/360; 20 T.C., at page 77. The Board of Referees sought to distinguish the decision of Rowlatt, J., in *Glazed Kid, Ltd.* v. *Commissioners of Inland Revenue*, 15 T.C. 445, where the company made a very similar arrangement to borrow from a bank the purchase price of shares on the terms that it paid over to the bank the dividends as received. Macnaghten, J., in reversing the decision of the Board of Referees, declared himself unable to see the distinction(1); and I agree with him. Rowlatt, J.'s judgments in Income Tax cases deserve, in my opinion, particular attention, but in this instance, with all respect to that learned Judge, his view cannot be upheld. He said (at page 456): "It is not open "to anyone to say that they" (the Glazed Kid company) "have not distributed "a reasonable part, when they could not distribute any part of what were "their profits because every penny of those profits, which solely consisted of "these dividends, were under contract receivable by somebody else". This is to confuse the use made of an income receipt to discharge a capital liability with the quite distinct question of the use of a credit balance on the profit and loss account to justify the distribution of a dividend.

As for paragraph 24 of the Stated Case, the Commissioners had contended before the Board of Referees that as the Company was purely an investment company, its profits should have been distributed to its shareholders. I do not think that this general proposition can be sustained; as already pointed out, the additional investments were highly profitable. There was no evidence that the Company could have financed its purchase on less onerous terms, and the Solicitor-General rightly admitted that it was no part of the case for the Revenue before this House that the Company should not have entered into this bargain with the bank. As Scott, L.J., observed, a finding that it was "not reasonable to make such a contract" is irrelevant(2).

There remains paragraph 25, which contains a finding of fact in the exact terms which would justify the Commissioners' direction under Section 21.

The question to be decided is whether there was evidence to support this finding of fact, and the answer to that question must be found by examining the contents of the Case and of the annexed documents. The Case does not state what the evidence was upon which the Board of Referees relied in coming to this conclusion. If the finding in paragraph 25 is to be treated as based upon the Board's view, expressed in paragraph 24, that the Company had not followed a reasonable course in making its agreement with the bank, then this view, as I have already pointed out, would not provide a firm foundation for the conclusion. Apart from this, the only material upon which the conclusion in paragraph 25 can be regarded as based is the fact, to be deduced from the

(1) *See* page 338 *ante*. (2) *See* page 341 *ante*.

**(Viscount Simon, L.C.)**

documents, that the Company might still pay a dividend if it could borrow the necessary amount on the equity of redemption of the deposited shares. This would be an unusual proceeding, and there is no evidence referred to in the Case that it would be commercially possible for the Company to do so, or to support the view that, in the circumstances, the failure to do so would amount to a failure to distribute a reasonable part of the Company's actual income. I do not forget that the Board of Referees is a tribunal of business men capable of applying a business judgment to the question before them, but I find it impossible to say that the Case contains conclusions of fact which will support the finding in paragraph 25, when in truth no such conclusions are formulated at all. There is no evidence on the matter to be found in the Case; and in the absence of material adequate to support the conclusion, I think the House is bound to answer the question put in the negative and to allow the appeal.

I move that the appeal be allowed with costs.

**Lord Atkin.**—My Lords, in the present case the Special Commissioners acting in pursuance of Section 21 of the Finance Act, 1922, as amended by subsequent Finance Acts, gave a direction that the whole income of the Appellant Company for the years 1936–37 and 1937–38 should be deemed to be the income of the members and should be apportioned among them. On appeal to the Special Commissioners as an appellate body they reversed the first decision; on appeal the Board of Referees reversed the latter decision; on further appeal Macnaghten, J., reversed the decision of the Board of Referees, and on still further appeal the Court of Appeal reversed the decision of Macnaghten, J. On appeal to this House I understand that your Lordships are unanimous in deciding to reverse the decision of the Court of Appeal.

There is no doubt that the Company comes within the terms of the relevant Section, which for this purpose is Section 14 (2) of the Finance Act, 1937: "In the case of a company to which section twenty-one of the Finance Act, "1922, applies, being an investment company, the following provisions shall "have effect:—(*a*) The Special Commissioners may, if they think fit, give "a direction under subsection (1) of that section if it appears to them that "the company has not within any year of assessment distributed to its "members, in such manner as to render the amount distributed liable to be "included in the statements to be made by the members of the company of "their total income for the purposes of surtax, a reasonable part of its actual "income from all sources for that year".

By the appropriate Sections dealing with appeals, the Board of Referees on appeal take the place of the Special Commissioners and can give the statutory direction. The Board are a special tribunal appointed indeed by the Treasury, though not to be lions under the Treasury chair, but to decide disputes judicially between Crown and subject, holding the scales impartially between them. No criticism at all has been directed against them in this respect. Their findings of fact are final; and their decisions can only be questioned on Cases Stated on points of law.

I must deal as briefly as possible with the facts stated before discussing the points of law raised in this case. The Appellant Company was incorporated in 1919 with a nominal capital of £25,000 divided into 15,000 ordinary and 10,000 preference shares of £1 each of which 15,000 ordinary and 1,765 preference shares have been issued as fully paid up. The Company was formed to acquire a retail jewellery and mail order business carried on at Bolton by Thomas Fattorini, and in June, 1919, it duly acquired the business for £14,754 paid as to £12,000 in fully paid shares and the balance in cash. There

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were at this time three other companies in existence in each of which Thomas Fattorini was the principal shareholder:—1. Thomas Fattorini (Skipton), Ltd., incorporated in 1919 with an issued capital at the material date of 47,980 ordinary and 4,200 preference shares of £1 each. 2. Thomas Fattorini (Birmingham), Ltd., afterwards named Thomas Fattorini, Ltd., with an issued capital of 13,480 ordinary shares of £1 each. 3. H. Pearson, Ltd., with an issued capital of 24,980 shares of £1 each.

Company No. 1 carried on a jewellery and mail order business at Skipton. Company No. 2 carried on the business of manufacturing medals and badges at Birmingham. Company No. 3 carried on the business of cycle dealers. Thomas Fattorini did not acquire his interest in this company until November, 1919. In 1924 the cycle business ceased and the company thereafter carried on a mail order business in Manchester.

In 1928 the Appellant Company discontinued its jewellery business, and sold its mail order business to company No. 1 for £14,000 which it lent to one or other of the three operative companies named. From that date, up to at any rate 1936, it carried on a blameless existence as an investment company, distributing annually dividends of about £500 or £600 derived from the interest on the above loans. In the Company as stated Thomas Fattorini was the principal shareholder, the other being apparently his son Wilfred.

In June, 1934, Thomas Fattorini died and his son Wilfred acquired his father's shares in the Appellant Company, being registered in respect of them in September, 1936. After that date he and his wife were the sole shareholders in, and directors of, the Company.

In the same year the Company proceeded to buy the shares held by the executors of the father and by his other son in the three above-named operative companies. The shares held by Frank were bought from him by an agreement made in the early part of 1936; the total price was £18,229 which the Company paid out of its own resources, realising the loan for that purpose. The shares were transferred in August, 1936.

At the same time the Company proceeded to buy the remaining shares in the operative companies, viz., those held by the executors of the father and by Wilfred himself. For these shares the price required amounted to a large sum, over £100,000, and it was necessary to get the assistance of the Company's bank to finance the transaction. These further shares amounted to 77,240 and the price to be found was about £105,000 so that the shares were bought at a premium. Accordingly the bank agreed to provide the necessary overdraft. They took as security all the shares in the operative companies, both those now to be purchased and those already purchased from Frank which, of course, provided some margin. They had stipulated that the loan should be paid off within two-and-a-half to three years; and in addition to a charge on the dividends they took from the Company an agreement until the loan was repaid to pay to the bank all the dividends it received from the shares in reduction of the amount due to the bank from time to time for payment of capital and interest. There was a stipulation that the companies should not during the period of the loan pay directors' fees in excess of £6,000 a year, a provision which suggests that Wilfred was not left without resources. But as far as the Company was concerned, for the time being it placed all its resources of every kind at the disposal of the bank, and was left without any income of any kind which it could, without the consent of the bank, devote to any purpose. There is no finding that this agreement was made in bad faith, or to avoid Sur-tax, and the Crown expressly disclaimed any attack upon it as being unreasonable. Indeed, it is easy to see that Wilfred and his wife as the directors and sole

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shareholders of the Company might congratulate themselves upon getting an advance from a bank on this class of security of so large an amount with the result that they secured in the near future a very valuable asset at the cost of forgoing for a few years dividends which so far had amounted to £500 or £600. The receipts from dividends during the years of charge were £6,540 and £34,855, or, deducting bank interest (in the first year for half a year), £5,340 and £31,140.

The Board of Referees have found that the Company had not within a reasonable time distributed in the manner referred to in the Section a reasonable part of its income for either period, and restored the direction of the first Special Commissioners that the actual income of the Company from all sources should be deemed to be the income of the members and the amount apportioned among them. It is unnecessary to emphasise the highly penal nature of the Section. It matters not how small a proportion of the whole income is the " reasonable part " found not to have been distributed. If the company are in fault over a few hundred pounds, the shareholders may be credited with many thousands of pounds with correspondingly heavy liabilities for Sur-tax. In the present case the Board of Referees have not found what would have been a reasonable sum to distribute. It is said that they have the support of some decision for this. If it be so, I can only say that the decision is wrong in a Case Stated such as this where the question is, was there evidence to support the decision? I find it impossible to approach the question whether there was evidence to support a finding that " a reasonable part " should be distributed, without knowing what part of it was considered reasonable to distribute, at least stated as a minimum. In the present case the Solicitor-General stepped into the breach and suggested that at least the Company should have distributed £500 or £600, an amount corresponding to its resources, before it embarked upon the purchase of the operative companies' shares.

The first question stated by the Board refers to a contention that under the agreement with the bank it would have been a breach of contract to distribute a dividend. No such contention was sought to be made by the Appellants before this House, and the question becomes irrelevant. The remaining questions are connected and should be set out.

In paragraph 24 of the Case the Board of Referees state: " We considered " that, as the Company was an investment company which, after " 24th August, 1936, held investments producing revenue for which the " Company had paid £18,000, there was a *prima facie* case that the reasonable " course was that the Company should so manage its affairs as to provide for " distribution of dividend; and that the Company had not displaced such " *prima facie* case by evidence that this could not have been done without " jeopardising the interests of the Company, or without making it impossible " to acquire the shares which it desired to buy."

Incidentally it is not to me clear whether this means that the Company had failed to produce the kind of evidence referred to, and that if they had produced the evidence they might have displaced the *prima facie* case; or means that there was evidence of the nature referred to but it did not displace the *prima facie* case. I think it probably means the former.

In paragraph 25 they say: " We found as a fact that the Company had not " within a reasonable time distributed in the manner referred to in Section 21 " of the Finance Act, 1922, a reasonable part of its income for either of the " periods in question."

The two questions now relevant posed by the Board are: " (2) Whether there " was evidence to support our finding of fact as set forth in paragraph 25.

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" (3) Whether the matters set forth in paragraph 24 are such as to shew that " we misdirected ourselves as to the onus of proof in a case where it is admitted " that an investment company with a substantial income has not distributed " any part of it."

I do not know whether there is any meaning in the inversion of order of the paragraphs in the question as put. In any case I should conclude that if the Board adopted a view as to the *prima facie* value of certain facts, and the failure of the Company to displace those facts, their final decision that the Company had not distributed a reasonable part of its income was necessarily based upon their expressed view of the *prima facie* case made and not displaced. On what other footing could the Board have reached a final decision on the facts? It would follow that, if they have in fact misdirected themselves in paragraph 24, their finding of fact in paragraph 25 is invalidated by this misdirection.

It seems clear that the discussion must proceed *ab initio* on the footing that the action of the directors must be judged by considering what their conduct would reasonably be if no question of Sur-tax influenced their decision. Withholding of distribution for the purpose of " avoidance of the payment of " super-tax " by shareholders would, if found, obviously negative the reasonableness of any part so withheld. The other general point to be observed is that, as it seems to me, what has to be found is that the Company acted unreasonably in withholding some part of its income from distribution. It is not enough to show that a part could reasonably be distributed, if at the same time it could be said, as it well might, that it was equally reasonable to withhold distribution. The Section is highly penal, and I feel no doubt that the onus is originally, and remains, on the Revenue to show that the Company acted unreasonably in withholding part of its income from distribution. What is reasonable has consistently been held to depend upon the actual conditions known at the time for decision. In the application of this Section it is what *these* directors recommend and *these* shareholders decide in *those* conditions of *that* company. There is no abstract conception of reasonableness, and the conclusion is not to be reached on *a priori* reasoning. Assuming that the directors are business men, have they acted unreasonably in the circumstances in withholding a distribution? From this point of view I am quite unable to agree that the fact that a company, even an investment company, during the year holds income producing investments, raises a *prima facie* case that the reasonable course for the company is so to manage its affairs as to provide for that income or any part of it to be distributed. It is certainly untrue of private commercial companies, of whom I have no doubt numbers are now prospering because the members have year after year placed all their profits in the business, and have forgone any income other than such as they may derive from directors' fees or the like. And I see no reason why the supposed rule should apply to investment companies, who are equally entitled if they choose to forgo their income for a time to develop and improve the company's undertaking. I think therefore that the answer to question (3) is that the matters referred to do show that the Board misdirected themselves as to the onus of proof.

But I also think that the facts stated by the Board disclose no evidence on which it could be found that the Company failed to distribute a reasonable part of its income in the years in question. We may eliminate the question which interested the Court of Appeal whether it was legal for the Company, having disposed legally of all its income for the year, to distribute a dividend at all. It was pointed out in the Court of Appeal that if the Company had made profits it would be perfectly legal to distribute them if it could secure the means to do so out of its other free assets or by borrowing. The point was not argued

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before us by Mr. Donovan in his cogent and convincing address. Whether it would be reasonable to exercise the legal right is another and the only relevant question. It will be convenient here to deal with the argument which was pressed upon us by Mr. Donovan that in the present case the dividends from the operative companies' shares formed the whole of the "actual" income of the Company within the meaning of Section 21 of the Act of 1922, and that as the whole of that "actual" income had been assigned to the bank there was no part of it which could have been distributed. My Lords, the Court of Appeal have effectively disposed of this argument. Actual income does not mean the specific receipts that come in from time to time, but the "Income Tax "income" as calculated at the end of the year of assessment. To hold otherwise would make nonsense of the Section when applied to commercial companies, who use their receipts as soon as they come in, and hardly ever have left for distribution the actual incomings as sought to be defined in the argument.

But when one begins to consider the circumstances of this Company at the end of this year when they had to consider the distribution of dividend, I am at a loss to see what was unreasonable in their decision to distribute nothing. There were only two shareholders, in substance only one, Wilfred. They had agreed shortly before by an agreement, which is not now in any way attacked, to assign the whole of their resources to the bank to secure what appeared to be a profitable and reasonable purchase. As a result the Company had not any asset left nor any source of free income. They therefore could not procure the funds with which to distribute a dividend without borrowing. They had no source of income from which they could pay interest on any loan. If they had to borrow from some one other than the bank they would have had therefore to pay some capital premium in lieu of interest calculated for the period of the bank loan; and presumably in the circumstances heavy. It was suggested that they might have approached the bank either for the necessary loan or to release some of the dividends. But the Company was represented by the very two people, the only persons interested, who had only a few months before, in an agreement which is unassailable, agreed to carry out the bank's stipulation that the loan should be paid off in two or three years by surrendering for the time being all the dividends. What is the overwhelming impulse to declare dividends that would now induce them to depart from the bank arrangement, or induce the bank to vary it? In view of these considerations, it appears to me that it was for the Inland Revenue authorities to give evidence indicating not only that it was possible for the Company to borrow (the Court of Appeal say that it would have been easy to borrow), but that in the circumstances it was the reasonable thing to do. In the result, therefore, I come to the clear conclusion that there was no evidence that the Company failed to distribute a reasonable part of its income. I regard the case as turning on the bank agreement. As long as that remains unassailed, it must necessarily have controlled the actions of the Company, and their reasonable decisions. The Court of Appeal spoke of "the whole plan in the "present case for protecting its two shareholders from Sur-tax"[1]. I cannot reconcile this phrase with their attitude towards the bank agreement; nor do I find it supported by any finding of the Board of Referees.

If the arrangement with the bank was in fact made as part of a plan for avoiding Sur-tax there might very well be evidence of a failure to distribute a reasonable part of the income. But in the absence of any evidence or finding to that effect, and in view of the Respondents' disclaimer of any attack on that agreement, it must be taken to represent a genuine business arrangement, and is a circumstance of the highest importance in estimating the reasonableness of the Company's action.

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[1] *See* page 342 *ante*.

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I am of opinion, therefore, that the answer to question (2) should be "No", and to question (3) "Yes"; that the appeal should be allowed and the Order of the Court of Appeal should be set aside, and the Order of Macnaghten, J., restored; and that the Respondents should pay the costs in this House and in the Court of Appeal.

**Lord Macmillan.**—My Lords, Sur-tax, like its predecessor Super-tax but unlike Income Tax, is charged not at a standard rate but on an ascending scale on successive portions of the total income of the taxpayer above a minimum. It is thus necessarily a tax on individuals. It is not levied on companies for it is not capable of being accommodated to the system whereby Income Tax is deducted from dividends at the source, inasmuch as the rates of Sur-tax vary with the incomes of the individual shareholders.

The immunity of companies from this tax has not unnaturally led to the adoption of various ingenious devices whereby individuals have sought to transform their income into the income of a company and so to escape the tax. The machinery of the Companies Acts and particularly the provisions applicable to private companies enabled this to be done with some success. But if such devices were to be effective it was necessary that the company should not distribute its profits in dividends, for dividends received by an individual must be included in the computation of his total income for Sur-tax purposes. Schemes were accordingly devised whereby the profits of the company should ultimately reach the shareholders otherwise than in the form of dividends, for example by way of loans or through a liquidation.

The legislation on the subject illustrates the usual competition in ingenuity between the tax gatherer and the tax evader, which has rendered the Revenue Statutes increasingly complicated.

The particular legislation with which your Lordships are concerned in the present case is designed to circumvent the expedient whereby the income of a company, in consequence of its refraining from distributing its profits, never reaches its shareholders in the form of dividends and accordingly never becomes liable to Sur-tax in their hands. The method which has been devised to defeat such schemes is to be found in Section 21 of the Finance Act, 1922, as amended by subsequent Acts. Thereby the Special Commissioners, where it appears to them that any company has not within a reasonable time after the end of any year distributed to its members "a reasonable part of its actual income", are empowered to direct that the said income shall be deemed to be the income of its members, among whom it shall be apportioned. The amount attributed to each member thus becomes part of that member's total income for Sur-tax purposes. This is a severe deterrent, for it subjects to Sur-tax the whole actual income of the company (on the assumption that all its members reach the Sur-tax level) and not merely such part of that income as it might be held to have been reasonable to distribute.

I need not rehearse at length the facts of the present case, which have already been fully set out by my noble and learned friend on the Woolsack. It is enough to say that the Appellant Company, which is an investment company within the statutory meaning, acquired shares in three commercial companies, chiefly with money borrowed from Martins Bank, on the terms that it should pay over to the bank all the dividends received in respect of all these shares until the indebtedness to the bank for capital and interest was completely satisfied. In accordance with the bank's requirements the certificates of the purchased shares were all deposited with the bank as security along with blank transfers and powers of attorney and a letter of deposit giving the bank an immediate power of sale. The Appellant Company had no income apart

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from the dividends on the shares which it had acquired. These dividends, in pursuance of the agreement with the bank, were all paid over to the bank, and the Company paid no dividends to its shareholders.

The question for the Special Commissioners was whether in their opinion the Appellant Company had not in the circumstances distributed a reasonable part of its actual income to its shareholders in the years in question. It appeared to them that this was so and they made directions accordingly. On appeal to the Special Commissioners in their judicial capacity these directions were discharged. At the instance of the Crown the case was re-heard by the Board of Referees, who took the contrary view and upheld the directions. On a Case stated by the Board, Macnaghten, J., reversed their determination, but the Court of Appeal subsequently restored it.

Regard being had to the form in which the matter comes before your Lordships' House, there is in my opinion only one question for decision, namely, whether on the facts as stated by the Board to have been found by them there was evidence on which they could in law decide as they did.

Two matters dealt with by the Board have first to be considered. They held (1) that as a matter of construction of the contract with the bank it would not have been a breach of contract for the Appellant Company to distribute a dividend. That is clearly right. But it is equally clear that it would have been a breach of contract to apply the dividends which the Appellant Company received and which were its sole source of income to payment of a dividend to its own shareholders. Therefore if the Appellant Company was to pay a dividend it must find the money from some other source than the dividends which it had itself received. The only possible source suggested by the Inland Revenue is that "if necessary the Company could lawfully have borrowed the "necessary money to enable it to make such distribution". But in the Stated Case the Board do not find in fact that the Company could have borrowed the necessary money or that it would in the circumstances have been reasonable for the Company to do so. Then (2) the Board found as a fact that if they were wrong in holding that the Company without breach of contract could have declared a dividend "it was not reasonable for the Company to make such a "contract". At your Lordships' Bar, however, the Solicitor-General, for the Crown, expressly disclaimed any attack on the Appellant Company's contract with the bank as being in itself unreasonable. I think this concession was rightly made for, considered apart from any question of taxation, the contract appears quite unobjectionable.

Once it is conceded that the contract is not assailable as unreasonable and consequently that it was not unreasonable for the Appellant Company to contract to pay over its whole income to the bank, it becomes difficult to see how it can be said to have been unreasonable to refrain from distributing dividends, which could have been provided only out of borrowed money. No indication is given of any grounds on which it would have been reasonable for the Company to borrow money to enable it to pay a dividend. If a dividend had been paid it would not in fact have been paid out of profits, but out of borrowed money. It would not have been a distribution of profits but a distribution of borrowed money which it was legitimate to distribute because a corresponding amount of profits had been earned.

What, then, is the finding in fact by the Board which your Lordships are asked to hold as justifying the Board's conclusion that the Appellant Company had not distributed in dividends a reasonable part of its income? It is to be found in paragraph 24 of the Stated Case, which expressed the opinion of the Board that "as the Company was an investment company which, after

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" 24th August, 1936, held investments producing revenue for which the " Company had paid £18,000, there was a *prima facie* case that the reasonable " course was that the Company should so manage its affairs as to provide for " distribution of dividend; and that the Company had not displaced such " *prima facie* case by evidence that this could not have been done without " jeopardising the interests of the Company, or without making it impossible " to acquire the shares which it desired to buy." The reference to the figure of £18,000 relates to the purchase price of the shares which the Appellant Company purchased from its own resources as distinct from the money borrowed from the bank.

It will be observed that the paragraph I have quoted puts the matter as one of onus. Now it may well be that, when the Special Commissioners make a direction under Section 21 of the 1922 Act, it is for the Company to put forward reasons and if necessary evidence to show why the direction is in the circumstances unjustified. Here the Appellant put forward its contract with the bank as justifying its having made no distribution of its income in dividends. And the Crown admit that it was quite reasonable for the Company to contract to apply its income as it did. It seems to me that it was then for the Crown to show that it would have been reasonable for the Company, notwithstanding its contract with the bank, to raise money by borrowing or otherwise in order to pay a dividend, as there was no legal obstacle to its doing so, and that the Company could in fact have raised the necessary money. There is no trace of any such evidence in the Case.

But when the matter reaches the stage of a Stated Case, the question is not properly one of onus. It is simply a question of whether the facts found and stated afford evidence on which the Board could properly arrive at their conclusion. Now, all that paragraph 24 of the Stated Case finds is that *prima facie* the reasonable course was that the Company should so manage its affairs as to provide for distribution of dividend. This is rather an expression of opinion than a statement of fact, and no grounds are given for it.

The result is that, in my opinion, the Board have not stated any facts such as to justify them in holding that the Appellant Company failed to distribute a reasonable part of its actual income in the years in question. I am accordingly in agreement with all your Lordships that the appeal should be allowed.

**Lord Wright.**—My Lords, I have considered in print the speech which my noble and learned friend the Lord Chancellor has delivered. I agree with it and merely add a few words as your Lordships are differing from the Court of Appeal.

The Board of Referees have embodied their decision in a Case stated for the opinion of the Court and have made it for present purposes subject to two questions of law. I disregard the first question, which is now irrelevant. As to the second question, which is whether there was evidence to support the Board's finding that the Company had not within a reasonable time distributed a reasonable part of its income for the periods in question, that is a question of law which depends on an analysis of the facts found in the Stated Case. But I think it cannot properly be disposed of without considering the other question, which is logically prior though postponed in the order in which the Case is stated. That latter is in truth a question as to the onus of proof, and can only be understood by referring to paragraph 24 of the Case. I understand that paragraph to mean that the Board are treating the onus as of an ambulatory or shifting character, so that at a certain stage of the enquiry it finally shifts from the Respondent to the Appellant. I think that is wrong in law. The Crown set out to prove that the direction of the Board is justified

**(Lord Wright.)**

because the Appellant Company has not distributed a reasonable part of its income within the meaning of Section 21 of the Finance Act, 1922. It is obvious that the Section is penal in character and in my opinion the onus is finally on the Crown to prove its right to impose what is a very severe penalty. At the end of the day it is for the Crown to establish the facts necessary to show want of reasonableness on the part of the Appellant. I cannot discover in the Case as stated that there are facts found sufficient to justify the conclusion. Nor do I think that the Board would have come to their conclusion if they had not taken the view as to onus expressed in paragraph 24. It was for the Crown to establish that the Appellant Company could have produced funds (it being accepted that the contract with the bank was not unreasonable), out of which to declare a dividend " without jeopardising the interests of the Company, " or without making it impossible to acquire the shares which it desired to " buy." I accept this here as a correct statement of what would have been sufficient, if established. The Board have not found that this has been proved. It seems to me that their conclusion in paragraph 25 was based upon their view as to the onus of proof. If the Board were wrong in that view, and I think they were, it follows that in law there was no evidence to support their finding of fact in paragraph 25.

**Lord Porter.**—My Lords, I agree that this appeal should be allowed and I think I can state with brevity my reasons for coming to this conclusion.

The facts have already been fully set out from the Woolsack, including in particular paragraphs 23, 24 and 25 containing the findings of the Board of Referees from which, as I understand it, that body draws its inferences and conclusion.

The Case ends by asking certain questions for the opinion of the Court, questions which as a result of the present appeal it is now incumbent upon your Lordships to answer.

As regards the first, I agree with the Lord Chancellor in thinking that it would not have been a breach of contract for the Company to distribute a dividend despite the fact that it had already assigned all its income to the bank in order to repay the loan obtained and had also hypothecated the whole of its assets for that purpose. Reference has already been made to the *Montague Burton* case, 154 L.T. 355, and 20 T.C., at page 77, which establishes this proposition.

In view of this opinion the alternative suggestion that it was not reasonable for the Company to make such a contract becomes immaterial, but I should not consider it material in any case. A company is entitled to manage its own business in its own way ; the question for the Board of Referees is not, as I see it, whether the Company has taken a reasonable course but whether, the particular course having been taken, the Company has distributed a reasonable part of its actual income. In saying this, I do not rule out the possibility that it may be seen in a particular instance that no genuine transaction has taken place and that the bargain made, actual or purported, is really a subterfuge merely adopted to avoid the payment of tax. I am not saying that such a state of affairs should not be taken into consideration in determining whether a reasonable part of a company's income has or has not been distributed. Moreover, I agree with the noble Viscount and with the Board that the decision in *Glazed Kid, Ltd.* v. *Commissioners of Inland Revenue*, 15 T.C. 445, is open to the objection that it appears to assume that a dividend, at any rate in the case of a holding company, can only be paid out of income received or receivable as cash. The fact that the income had been invested or hypothecated for some purpose elsewhere would not of itself necessarily prevent the distribution of a dividend.

**(Lord Porter.)**

Subject to the qualification that the opinion of the Board of Referees as to the reasonableness of the contract entered into is in this case an immaterial consideration, I should answer the first question asked by the Case in the affirmative.

There is however, as I think, more difficulty in answering the second question. As I understand the framework of the Case, the deductions and inferences drawn by the Board from the history of the transactions set out in the earlier paragraphs are brought to a conclusion in paragraph 24, and therein are to be found the grounds from which it is determined that a reasonable distribution of income has not been made.

Those reasons are, I think, as follows :—(1) The Company is an investment company. (2) It held income producing investments which cost £18,000. (3) Having those investments it should have managed its business in such a way as to insure that the Company enjoyed the income produced by them either directly or indirectly. (4) The Company had not proved that it could not have kept this income without endangering its interests and without preventing itself from purchasing the shares acquired by means of the loan from the bank.

(1) The Company is indeed an investment company, and I suppose it is possible to say that in such a case the necessity for building up considerable reserves may not be so imperative as in the case of a trading company. At any rate the Board was entitled to think so even in the case of a Company holding somewhat speculative shares. But this circumstance seems to have little bearing upon a case where the putting by of reserves does not come in issue, but only the making of a speculative but profitable investment.

(2) and (3) Nor does it seem to me of much assistance to say that the Company once held and, subject to the bank's interest, still holds investments costing £18,000. The question is what distributable revenue those investments do or ought to produce. The statement in its bald form appears only to be another way of saying that the purchase of the additional shares ought either not to have been made at all or, at any rate, ought not to have taken the form it did, and seems to merge in allegation (4), viz., that it had not been proved impossible to acquire those shares in some other way.

(4) To say that it would have been possible to raise the loan required on less onerous terms without any suggestion as to how it could have been done or whence the money could have been obtained is indeed to enter the realm of conjecture. In fact, the money was raised by loan from the bank and in fact the bank insisted upon the terms agreed ; indeed, so far as the evidence is concerned, it was anxious to have the total sum repaid at an earlier date than that finally stipulated.

If, then, positive evidence is required to support the finding in paragraph 25 of the Stated Case that the Company had not distributed a reasonable portion of its income, I can find none. So far as the bank is concerned it is negatived, and so far as any other source is concerned it is merely conjecture. Indeed, as I think, paragraph 24 depends, and having regard to the form of the Case Stated depends solely, upon the assumption that the onus of proof is on the Company to show, not that it could have raised money to pay a dividend after making the bargain into which it had entered, but that it could have made a better bargain.

If the finding in the Case had been that the Appellants could, and should reasonably, have raised money or credit upon the equity of redemption of the

**(Lord Porter.)**

assets pledged to the bank, and so could have provided funds sufficient to declare a dividend, or even that it would have been reasonable to raise the money in this way and the Appellants had not shown they could not do so, I should have hesitated in differing from the Court of Appeal.

But that is not how I understand the Board to have reached the result arrived at. It is the bargain with the bank of which they complain, not the failure of the Company, once that bargain was made, to obtain such funds as would enable it to distribute a dividend.

If the contract with the bank had not been, as it obviously was, a genuine transaction, but only a matter of avoiding tax, or if it had been found that the directors of the Company could, and as reasonable business persons should, have borrowed on the security of their equity of redemption, or even that, as reasonable business persons, they should have done so if they could, and had not been shown that they could not, I should be unwilling to vote for allowing the appeal.

But there is no such finding and I do not think that the Respondents' case is strengthened by a suggestion that quite a small sum should have been raised for the purpose. The question is what should reasonably have been done. If it was possible and reasonable for the Appellants to borrow at all in the present case, I think the facts found would support the inference that a considerable sum could have been borrowed just as readily as they would support the inference that a small one should have been borrowed. But I do not think they support either. The Appellants' duty is to act reasonably, not to adopt any and every means in order to scrape up enough money to declare a dividend, however small.

It will be seen that the opinion which I have expressed is based upon the exact findings of the Board of Referees as I understand those findings. May I add that it would assist a tribunal, to which a Case Stated is referred, if the facts found were carefully separated from the inferences of fact and law based upon them, and if those inferences themselves were clearly distinguished. In *Bomford* v. *Osborne* (also a tax case), reported in [1941] 2 All E.R. 426; 23 T.C. 642, I expressed the view that in setting out a Case it was not legitimate, after stating the facts, to reach a certain conclusion by saying that such and such a thing is found as a fact. I am still of this opinion, and think that the final conclusion is not a fact but an inference from facts previously set out, and that, therefore, that conclusion is not binding upon the tribunal to which the Case is referred unless it appears from the previous findings that there are facts which support it. In the present case I cannot find such support and should allow the appeal.

*Questions put:*

That the Order appealed from be reversed.

*The Contents have it.*

That the judgment of Macnaghten, J., be restored and that the Respondents do pay to the Appellants their costs here and in the Court of Appeal.

*The Contents have it.*

[Solicitors:—Biddle, Thorne, Welsford & Barnes, for Charlesworth, Wood & Brown, Skipton; Solicitor of Inland Revenue.]

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