HIGH COURT OF JUSTICE (CHANCERY DIVISION)—
18TH, 19TH AND 20TH MARCH 1964

COURT OF APPEAL—21ST, 22ND, 23RD, 26TH, 27TH AND 28TH OCTOBER AND 26TH NOVEMBER 1964

HOUSE OF LORDS—14TH, 18TH, 20TH AND 21ST OCTOBER AND 15TH DECEMBER 1965

B. W. Nobes & Co. Ltd. *v.* Commissioners of Inland Revenue[1]

Income tax—Annual payment—Payment charged against capital in payer's accounts—Profits exceeding annual payment but less than aggregate of annual payment and dividend paid—Whether annual payment made wholly out of taxed profits—Income Tax Act 1952 (15 & 16 *Geo.* 6 & 1 *Eliz.* 2, *c.* 10), *s.* 170.

The Appellant Company carried on business as shipbrokers. In May 1957 *it formed a subsidiary, A Ltd., with an authorised capital of* 100 £1 *shares, two of which were allotted to the Company. In July* 1957 *the other* 98 *shares were allotted to it in consideration of a covenant to make to A Ltd. for nine years annual payments from which income tax was deductible. In the same month the Company sold the whole share capital of A Ltd. to C Ltd. for* £45,000, *of which* £100 *was payable on completion and the remainder by instalments over nine years. Each year from* 1958 *to* 1960 *before making the covenanted payment to A Ltd. the Company arranged with C Ltd. to receive a cheque for the same amount under the sale agreement, and a ledger account opened by the Company showed each payment to A Ltd. as balanced by a receipt from C Ltd. The balances on profit and loss account for the three years to* 31*st March* 1960 *were not affected by the payments to A Ltd. According to its accounts for each of those years, the Company had taxed profits sufficient to cover the annual payments to A Ltd., but not to cover both those payments and the dividends from which it deducted tax. A document submitted by the Company purported to show an accumulated balance of taxed profits at* 31*st March* 1957 *of* £74,188, *but the accounts showed the balance at that date as* £4,449.

The Company was assessed to income tax under s. 170, *Income Tax Act* 1952, *for the years* 1957-58 *to* 1959–60 *on the footing that the payments to A Ltd. were not wholly made out of profits brought into charge to tax. On appeal, it was contended for the Company that there were in each of the relevant years sufficient taxed profits to cover the payments to A Ltd. and that those payments must therefore be deemed to have been made wholly out of taxed profits. For the Crown it was contended that the Company had not discharged the onus which lay on it to show that the payments were made out of taxed profits, and that the evidence showed that they were in fact made out of capital receipts. The Special Commissioners found that there was no evidence that the Company had had recourse to an accumulated fund of taxed profits, and having regard to the dividends paid under deduction of tax and to the ledger account concluded that the annual payments were made entirely out of capital.*

Held, *that the Commissioners' decision was correct.*

[1] Reported (Ch. D.) [1964] 1 W.L.R. 761; 108 S.J. 521; [1964] 2 All E.R. 140; (C.A.) [1965] 1 W.L.R. 229; 108 S.J. 1030; [1965] 1 All E.R. 327; 236 L.T. Jo. 107; (H.L.) [1966] 1 W.L.R. 111; 110 S.J. 55; [1966] 1 All E.R. 30.

CASE

Stated under the Income Tax Act 1952, ss. 170(4) and 64, by the Commissioners for the Special Purposes of the Income Tax Acts for the opinion of the High Court of Justice.

1. At meetings of the Commissioners for the Special Purposes of the Income Tax Acts held on 19th and 20th March 1962 and 17th January 1963, B. W. Nobes & Co. Ltd. (hereinafter called "the Company") appealed against assessments to income tax made under s. 170 of the Income Tax Act 1952 for the years 1957–58, 1958–59 and 1959–60 in the sums of £43,870 (tax £18,644 15*s.*), £47,126 (tax £20,028 11*s.*) and £43,329 (tax £16,789 19*s.* 9*d.*) respectively.

2. The question for our determination was whether certain annual payments by the Company had not been made or had not wholly been made out of profits or gains brought into charge, within the meaning of s. 170 aforesaid.

3. (*a*) On behalf of the Company Mr. James William Clement gave evidence before us. He is a Fellow of the Institute of Chartered Accountants, and a partner in the firm of Blackburns, Robson, Coates & Co. This firm audited the Company's accounts at all material times, and Mr. Clement was the partner responsible for the audit.

(*b*) On behalf of the Crown Mr. Gareth Barlow Baron gave evidence before us. He is a Fellow of the Institute of Chartered Accountants, and chief accountant to the Board of Inland Revenue.

4. The Company at all material times carried on the business of shipbrokers, and has made up its accounts to 31st March each year.

5. In August 1955 all the shares in the Company were sold to a company called Avenue Finance Co. Ltd. On 25th March 1957 the Company paid a dividend of £155,000 net, leaving on its profit and loss account to 31st March 1957 a balance to be carried forward of £4,449.

On 31st March 1957 Avenue Finance Co. Ltd. sold all its shares in the Company to the Company's present parent company, Fashion & General Investment Ltd., for about £17,000.

6. On 16th May 1957 the Company caused Aconite Investments Ltd. ("Aconite") to be incorporated, with an authorised share capital of £100 consisting of 100 shares of £1 each, of which two shares were allotted to the Company for cash.

7. On 12th July 1957 the Company entered into a deed of covenant with Aconite. This deed provided that:

(i) in each of the years ended 5th April 1958 to 1966, inclusive, the Company should pay to Aconite the greater of the two following sums, namely:

(*a*) a sum equal to the net annual income (as defined) in the year ending on 30th March which falls within the fiscal year arising on certain shipping contracts, provided nevertheless that the said sum should not in any event exceed the income from all sources of the Company assessable to or charged with income tax in the fiscal year, reduced by all annual payments as defined in s. 169 of the Income Tax Act 1952 except the said sum payable under the deed,

(*b*) one hundred pounds;

(ii) income tax at the standard rate should be deducted from these payments, which would become due and payable on 30th March in each year;

(iii) in consideration of the giving of the covenant to make the payments Aconite should forthwith issue and allot to the Company (or as it might direct) 98 shares of £1 each credited as fully paid up.

It is common ground that these payments are annual payments from which tax was properly deducted, and it is in relation to them that the question arises whether they were paid out of the Company's profits or gains brought into charge, or partly so paid.

The shares in Aconite were a fixed capital asset of the Company which were acquired by means of the covenant to make the annual payments.

A copy of this deed of covenant is annexed hereto, marked "A", and forms part of this Case(1).

8. On 18th July 1957 the Company entered into an agreement with Consolidated Investment Funds Ltd. ("C.I.F.") whereby it agreed to sell all its 100 £1 shares in Aconite to C.I.F. The primary price payable by C.I.F. was £45,000, of which £100 was payable on completion (18th July 1957); but the primary price was subject to a possible increase. The agreement provided that sums equal to Aconite's net profits (as defined) for the financial period ended 31st March 1958 and each of the years ended 31st March 1959 to 1966. inclusive, were to be paid on account of the primary price; but that if the aggregate of such sums and of the £100 payable on completion exceeded £45,000, the primary price was to be increased by the excess. The agreement also provided that the payments by C.I.F. were to be paid to and received by the Company as capital sums on account of the purchase price of the Aconite shares.

A copy of this agreement is annexed hereto, marked "B", and forms part of this Case(1).

9. The Company opened a ledger account in its books, headed "Shares in Aconite Investments Ltd.", in respect of the acquisition and sale of the said shares.

A copy of this account for the period from July 1957 to July 1961 is annexed hereto, marked "C", and forms part of this Case(1).

On the left-hand side there are debited the net annual payments made by the Company to Aconite, and the capital payments made by C.I.F. to the Company are credited on the right-hand side.

In the period covered by the account it balances year by year. The explanation of, for example, the early figure on each side of £225 4*s*. 6*d*. is that the Company paid on 25th March 1958 £25,000 on account of its annual payment to Aconite. Subsequent calculation showed that this sum was £225 4*s*. 6*d*. too little. £225 4*s*. 6*d*. was paid to Aconite, and a corresponding sum paid by C.I.F. to the Company. The final calculation shown in the account of the annual payments from the Company to Aconite was accurate, but the payment of the corresponding sums from C.I.F. to the Company was merely provisional. These latter payments were made on account of the sums due from C.I.F. to the Company under the agreement of 18th July 1957, but the final calculation of those sums would not (as appears from the documents) necessarily or normally correspond with the calculation of the annual payments due from the Company to Aconite. Thus the balance of the account did not truly reflect the effect of the agreement, but simply meant that the Company did not, in the period

(1) Not included in the present print.

covered by the account, take credit for any actual surplus arising on the transaction.

Each year from 1958 to 1960, before making the payment to Aconite under the deed of covenant (exhibit A), the Company arranged with C.I.F. to receive a cheque for the same amount from C.I.F. under the agreement dated 18th July 1957 (exhibit B).

10. (*a*) The two transactions of (1) the subscription by the Company for the Aconite shares by means of the covenant to make the annual payments and (2) their sale to C.I.F. in consideration of a series of capital payments were related transactions in the sense that they were both decided upon by the Company at the same time. They were put through the one ledger account because, in Mr. Clement's opinion, this was a natural and convenient way of dealing with them. Since the ledger account balanced year by year, the transactions of subscription for and sale of the Aconite shares were not reflected in the Company's audited accounts for the three years to 31st March 1960 except by way of notes on the balance sheets (reference to the Company's accounts will be made later) and of course the Company's balance on profit and loss account was not affected by the annual payments to Aconite.

(*b*) Mr. Clement explained that there was another sound accountancy method of dealing with these transactions. The annual payments to Aconite could be debited direct to the profit and loss account, and since they would not appear in the ledger account there would be a surplus on that account in respect of the payments by C.I.F. to the Company: Mr. Clement agreed that these payments by C.I.F. were capital receipts and that this surplus would be a capital surplus.

Where a capital asset is being acquired by means of an undertaking to make revenue payments, it is not general accountancy practice to debit the revenue payments to profit and loss account, but if they were so debited it would be proper to credit the account with an equal amount unless it was clear that the value of the capital asset so acquired was less than it cost.

(*c*) In fact, a form of this method was adopted in the Company's accounts for the year to 31st March 1961. It was adopted because Mr. Clement knew that the assessments under appeal had been or were about to be raised, and he thought that the only ground on which they could be based was the form of the ledger account. A copy of these accounts is annexed hereto, marked "D", and forms part of this Case[1].

It will be seen that the net amount of the payment to Aconite, £22,706, is debited to the profit and loss account, which shows a loss of £2,742. In the appropriation account this loss is brought down, and the sum of £22,706 is credited, described as "Transfer to cost of Shares in former Subsidiary of an amount equal to net payment under deed of covenant made in favour of that Company in subscription for its shares". The result of these entries is to leave a balance of £26,448 to be carried forward.

Mr. Clement regarded the surplus of capital receipts which would arise on this method in the ledger account as the Company's income in the broad sense of receipts from all sources which it was not obliged to retain as capital. The surplus would be available for the payment of a dividend, as the appropriation account indicates, although no dividend was in fact paid for this year.

[1] Not included in the present print.

(*d*) There is another sound form of this method: the Company's accounts for the year to 31st March 1958, a copy of which, marked "E", is annexed hereto and forms part of this Case([1]), was taken as an example. In the profit and loss account (last page) Mr. Clement would prefer to deduct the payment to Aconite from the "Net Trading Profit" of £43,631, since the payment would not be a trading expense; but it could have been deducted from the "Commissions Earned" of £86,336.

(*e*) Perhaps we should add what is really obvious: whether the ledger account balances year by year or whether the payment to Aconite is debited to profit and loss account with a corresponding credit in the appropriation account, the amount available for distribution by way of dividend will remain the same. But, as we understood Mr. Clement's evidence, on the latter method part at least of this available amount, appearing in the appropriation account, will consist of the capital surplus thrown up on the ledger account, for the reason that the annual payment is debited in the profit and loss account and not in the ledger account.

11. (*a*) The directors' report on the Company's accounts for the year to 31st March 1958 (at page 1 of exhibit E) shows a net profit after taxation of £26,725, to which are added a waiver by the managing director of a prior year's remuneration and the balance of £4,449 on profit and loss account brought forward from the previous year, making a total of £35,774. Net dividends (after deduction of tax) totalling £34,349 were paid, leaving a balance to be carried forward of £1,425.

(*b*) A copy of the Company's accounts for the year to 31st March 1959 is annexed hereto, marked "F", and forms part of this Case([1]). The directors' report (page 1) shows a net profit after taxation of £23,002, to which are added a waiver by the managing director of a prior year's remuneration and the balance of £1,425 on profit and loss account brought forward from the previous year, making a total of £26,727. A net dividend (after deduction of tax) of £24,500 was paid, leaving a balance to be carried forward of £2,227.

(*c*) A copy of the Company's accounts for the year to 31st March 1960 is annexed hereto, marked "G", and forms part of this Case([1]). The directors' report (page 1) shows a net profit after taxation of £26,307, to which is added a waiver by the managing director of a prior year's remuneration and the balance of £2,227 on profit and loss account brought forward from the previous year, making a total of £30,984. A net dividend (after deduction of tax) of £24,500 was paid, leaving a balance to be carried forward of £6,484.

(*d*) During the three above-mentioned years the Company made to Aconite the annual payments, from which tax was deducted, which are set out in the ledger account (exhibit C).

(*e*) It is apparent from the above-mentioned figures that the Company had for each of the relevant years sufficient taxed profits to cover the annual payments to Aconite, but that it did not in each of those years, considered by itself, have sufficient taxed profits to cover these payments and also the dividends from which it deducted tax.

12. There is annexed hereto, marked "H", and forming part of this Case, a document headed

([1]) Not included in the present print.

"B. W. Nobes & Co. Limited. Summary for the income tax years of assessment 1951–52 (from commencement of trading on 29th August 1951) to 1959–60 of income tax assessments; annual payments; and dividends paid during those years." A

This document is, we think, self-explanatory.

13. The following cases were cited to us: *Attorney General* v. *London County Council*(1) 4 T.C.265; *Edinburgh Life Assurance Co.* v. *Lord Advocate*(2) 5 T.C.472; *Sugden* v. *Leeds Corporation*(3) 6 T.C.211; *Corporation of Birmingham* v. *Commissioners of Inland Revenue*(4) 15 T.C.172; *Central London Railway Co.* v. *Commissioners of Inland Revenue*(5) 20 T.C.102; *Allchin* v. *Corporation of South Shields*(6) 25 T.C.445. B

14. It was contended on behalf of the Company:

(1) that the form of the ledger account, being a matter of the Company's domestic accounting, was irrelevant; C

(2) that the amount available for distribution by way of dividend from which tax could be, and was in fact, properly deducted remained the same whether the annual payments to Aconite were debited in the Company's profit and loss account or in the ledger account;

(3) that there were in each of the relevant years sufficient taxed profits of the Company to cover the annual payments to Aconite; D

(4) that it was lawful for the Company to make the annual payments to Aconite out of the above mentioned taxed profits;

(5) that on the authorities the Company must therefore be deemed to have made the annual payments to Aconite in the relevant years wholly out of its fund of taxed profits. E

15. It was contended on behalf of the Commissioners of Inland Revenue:

(1) that the onus was on the Company to show that the annual payments to Aconite were made out of the Company's profits or gains brought into charge, within the meaning of s. 170 of the Income Tax Act 1952;

(2) that this onus has not been discharged;

(3) that the evidence shows that the annual payments to Aconite were in fact made out of capital receipts. F

16. We, the Commissioners who heard the appeal, reserved our decision, and gave it in writing on 31st May 1962, as follows.

We think that the position on the authorities, put shortly, is that, if a company has profits and gains brought into charge sufficient in amount to cover the payment of interest or other annual payments, it is to be deemed, *in the absence of evidence to the contrary*, to have made the annual payments out of its taxed fund. In the present case the Appellant Company had profits and gains brought into charge in each of the relevant years which were sufficient in amount to cover the annual payments to Aconite. We must, therefore, consider whether there is evidence to show that these annual payments were not made out of the Appellant Company's fund of taxed profits; and for this purpose we do not G H

(1) [1901] A.C. 26. (2) [1910] A.C. 143. (3) [1914] A.C. 483. (4) [1930] A.C. 307.
(5) [1937] A.C. 77. (6) [1943] A.C. 607.

take as conclusive the form of the ledger account, which does indicate that they were made out of instalments of capital received from C.I.F. In our view there is such evidence, which is conclusive. The Appellant Company in each relevant year paid dividends from which it deducted tax, and the total of these dividends together with the annual payments to Aconite greatly exceeded the amounts of its profits and gains brought into charge. Under s. 184 of the Income Tax Act 1952, a company is entitled to deduct tax from dividends only in the case where the dividends are paid out of profits and gains which have been charged to tax. Since the Appellant Company deducted tax from the dividends which it paid, it seems to us to follow that the only source for the payment of these dividends was its fund of taxed profits, and that, to the extent that the dividends were paid out of this source, the same source cannot be available for the making of annual payments to Aconite.

We hold that the appeal fails, and we leave the figures to be agreed.

17. The parties were not able to agree the figures on the basis of our decision, and there was a further hearing on 17th January 1963.

18. At this hearing two further documents were produced in evidence.

(*a*) A document headed

"B. W. Nobes & Co. Limited. Table of income (as adjusted for income tax purposes, see footnote), covenant payments, and dividends paid in the Company's $10\frac{1}{2}$ financial years ended 31st March 1962."

A copy of this document is annexed hereto, marked "I", and forms part of this Case([1]). It is self-explanatory, and is linked with exhibit H. There is a slight error in document I. In the first line the figure in the column headed "Total Income" is £376,409: this should be £376,609, the figure which appears in column 8 of exhibit H in the line "Year of Assessment ended 5th April 1957". A reference to the footnote to document I shows that, for example, the figures of £115,328 and £1,453 for the year ended 31st March 1957 appear in exhibit H under the year of assessment ended 5th April 1958.

(*b*) A document headed

"B. W. Nobes & Co. Ltd. Calculation of Section 170 Assessments for the five years 1957–58 to 1961–62, based on the Special Commissioners' Decision on the Appeals (for the first three of those years)."

A copy of this document is annexed hereto, marked "J", and forms part of this Case([1]).

During argument on behalf of the Company, the possible method of calculation illustrated in the first part of the note was not pursued, it being agreed that to gross up at 8*s.* 6*d.* in the pound the balance on the Company's profit and loss account at 31st March 1957 (£4,449) was not in any view a proper method of calculating s. 170 assessments on the basis of our previous decision. The method adopted on behalf of the Company was "the alternative view" in the second paragraph of the note. The reference to exhibit 13 is a reference to exhibit H: the figure of £302, 421 will be found in column 11 of that exhibit, on the line "Year of Assessment ended 5th April 1957".

19. It was contended on behalf of the Company:

(1) that, in deciding whether the dividends paid under deduction of tax by the Company were paid out of profits or gains brought into charge, the

([1]) Not included in the present print.

Company was entitled on the authorities to look to the balance of taxed profits of previous years, and not merely to the taxed profits of the years under appeal; A

(2) that on the figures shown in the alternative (and correct) view in exhibit J there were ample taxed profits to provide for both the Aconite payments and the dividends paid under deduction of tax for the years under appeal;

(3) that consequently the Aconite payments had been made out of profits or gains brought into charge, and the assessments under appeal should be discharged. B

20. It was contended on behalf of the Commissioners of Inland Revenue:

(1) that it was not legitimate to work backwards to years previous to the years under appeal till there was discovered a balance of taxed profits which could be carried forward to the years under appeal to provide a fund of taxed profits out of which it could be said that both the Aconite payments and the dividends had been paid; C

(2) that we must consider what on the evidence the Company had in fact done;

(3) that the evidence showed that the Company in fact had made the Aconite payments entirely out of capital, and that, consequently, the assessments under appeal should be confirmed. D

21. We, the Commissioners who heard the appeal, reserved our decision, and gave it in writing on 26th March 1963, as follows:

We are still of opinion that this appeal fails, but now for reasons rather different from those in our earlier decision: and we regret any inconvenience this change of view may cause. We did not in our earlier decision mean to imply that we had paid but slight attention to the ledger account, and we now think E it of more importance than we did previously.

In *Corporation of Birmingham* v. *Commissioners of Inland Revenue*(1) 15 T.C.172, Lord Atkin, at page 213, propounds two questions:

> "(1) Have the interest and the annuities been, in fact, paid, or must they, in the circumstances of the case, be taken to have been, in fact, paid out of profits or gains brought into charge, i.e., out of the so-called 'taxed F fund'? (2) Was it lawful to pay them out of that fund?"

At page 214, he says: "But the first question remains, did they in fact do so?" and lower down on the same page, in considering the question whether the Corporation was not entitled to retain the tax deducted, he says: "This can only be on the footing that they have in fact paid the interest out of their untaxed funds." These sentences appear in their terms to qualify to some extent his G earlier phrase: ". . . must they, in the circumstances of the case, be taken to have been, in fact, paid . . ." But we think we must in the present case ask the question: Did the Company in fact make the annual payments out of its taxed funds, or did it in fact make them out of capital since it was certainly lawful to make them out of taxed funds? It is on this question that we now attach more importance to the ledger account than we did previously. H

In *Central London Railway Co.* v. *Commissioners of Inland Revenue*(2) 20 T.C.102, at page 141, Romer L.J. is considering this question of the form of

(1) [1930] A.C. 307. (2) [1937] A.C. 77.

A accounts: having said that, where interest has in fact and as a matter of convenience been paid out of a fund no part of which consists of profits or gains brought into charge, he goes on to say that in the proper circumstances, in the absence of evidence to the contrary, the payment may be deemed to have been made out of profits or gains. But he continues, lower down on page 141:

> "I do venture to say this, that, where, not for the purposes of con-
> B venience or for the purposes of giving effect to the payer's own notions of account keeping, but for the purpose of definitely deciding and of recording the fact that a decision has been come to that a certain payment of interest is to be paid out of capital and not out of interest, then the account is not only of great importance but, in the absence of evidence to the contrary, is conclusive upon the matter."

C We realise that in the *Birmingham Corporation* case(1) the form of the account resulted in the Corporation's receiving a subsidy, and that in the *Central London* case(2) it resulted in preventing the diminution of the dividend fund. The ledger account is drawn up on the basis that the Company made annual payments out of capital receipts, and we would find, in the circumstances of this case and in the absence of evidence to the contrary, that it was so drawn up for the D purpose of recording the fact that the Company had come to a decision that the annual payments were in fact made out of capital. In the relevant years the Company did not have sufficient taxed profits to cover the total of its annual payments and the dividends from which it deducted tax. The contrary evidence that the ledger account did not record a decision that the annual payments were in fact made out of capital would have to be that the Company, in order to E make both the above-mentioned payments out of its "taxed funds", had had recourse to its accumulated balance of taxed profits. We find that there is no such evidence, and we therefore further find that the annual payments were made entirely out of capital.

The appeal fails.

We were given to understand that on the basis of the above finding the F assessments under appeal should be confirmed as they stand, and accordingly we confirm them.

22. The Appellant immediately after the determination of the appeal declared to us its dissatisfaction therewith as being erroneous in point of law and required us to state a Case for the opinion of the High Court pursuant to the Income Tax Act 1952, ss. 170(4) and 64, which Case we have stated and do G sign accordingly.

23. The question of law for the opinion of the Court is whether we were entitled to find that the Aconite payments had been made out of profits or gains not brought into charge.

R. W. Quayle
H. G. Watson
} Commissioners for the Special Purposes of the Income Tax Acts.

H

Turnstile House,
94-99 High Holborn,
London W.C.1.

28th November 1963.

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(1) 15 T.C. 172. (2) 20 T.C. 102.

EXHIBIT H

B. W. NOBES & CO. LIMITED — 10th March 1962

Summary for the income tax years of assessment 1951–52 (from commencement of trading on 29th August 1951) to 1959–60 of income tax assessments; annual payments; and dividends paid during those years.

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
Years of Assessment ended 5th April	*Taxed Income*				*Annual Payments under Deed of Covenant*	*Taxed Income less Annual Payments*			*Dividends, Gross*	
	Sch. D, Case I	Sch. D, Case III	Taxed at source	Total		For the year	Cumulative balance	Date paid	Paid in the year	Cumulative
	£	£	£	£	£	£	£		£	£
1952	33,610	—	5	33,615	—	33,615	33,615	—	—	—
1953	70,170	—	126	70,296	—	70,296	103,911	28/2/53	3,333	3,333
1954	56,123	802	619	57,544	—	57,544	161,455	—	—	3,333
1955	56,289	1,209	320	57,818	—	57,818	219,273	30/6/54	3,473	15,489
								29/11/54	8,683	
1956	70,605	1,209	235	72,049	—	72,049	291,322	17/8/55	17,367	32,856
1957	82,903	2,814	200	85,287	—	85,287	376,609	23/3/57	269,565	302,421
1958	115,328	1,453	198	116,979	43,870	73,109	449,718	27/3/58	15,737	318,158
1959	46,853	2,022	195	49,070	47,126	1,944	451,662	22/5/58	44,000	362,158
1960	48,949	1,069	175	50,193	43,329	6,664	458,526	13/5/59	40,000	402,158
	580,830	9,948	2,073	592,851	134,325	458,526			402,158	

A The case came before Plowman J. in the Chancery Division on 18th, 19th and 20th March 1964, when judgment was given against the Crown, with costs.

Sir Andrew Clark Q.C., *M. P. Nolan* and *J. Holroyd Pearce* for the Company.

F. N. Bucher Q.C., *E. Blanshard Stamp* and *J. Raymond Phillips* for the Crown.

B **Plowman J.**—This is an appeal by B. W. Nobes & Co. Ltd. against a decision of the Special Commissioners confirming assessments to income tax made on the Company for the years 1957–58, 1958–59 and 1959–60. The assessments were made under s. 170 of the Income Tax Act 1952, in respect of certain annual sums paid by the Company under a deed of covenant to which I will refer later. The gross sums for each of the three years in question were C £43,870, £47,126 and £43,329. In making those payments the Company deducted tax, and rightly so, but the point in issue is whether, as the Company claims, the sums in question were paid wholly out of profits or gains brought into charge to tax, so as to entitle the Company, by virtue of s. 169 of the Act, to retain the tax deducted or whether, as the Crown says, they were paid out of capital so as to make the Company accountable for the tax under s. 170.

D The facts are these. The business of the Company is that of shipbrokers. It made up its accounts to 31st March each year, and the relevant period in this case covers the three years ended 31st March 1958, 1959 and 1960. At the beginning of that period, that is to say, on 31st March 1957, the Company had a balance on its profit and loss account of £4,449, but in fact the total taxed profits of the Company from the date it started trading in the year 1951, less E dividends paid by it, was £74,188 at 31st March 1957. That sum was available to frank further dividends but it was not available, for the purposes of s. 169, for payment of the annual sums I have referred to, during the relevant period, because it represents profits for the wrong years for s. 169 purposes. In May 1957, the Company caused another company to be incorporated, Aconite Investments Ltd., to which I will refer as Aconite. That company was incorporated with a F capital of £100 divided into 100 shares of £1 each, two of which were issued to the Company for cash. On 12th July 1957, the Company entered into a deed of covenant with Aconite. Under that deed, in consideration of the allotment to the Company of the other 98 shares of Aconite, credited as fully paid, the Company covenanted to pay to Aconite, in each of the nine years from 5th April 1958 to 5th April 1966, a sum equal to the net income of the Company G in each of the years ending 30th March 1958 to 30th March 1966, derived from certain shipping contracts, subject to a proviso that:

> "the said sum should not in any event exceed the income from all sources of [the Company] assessable to or charged with income tax in the fiscal year reduced by all annual payments as defined in Section 169 of the Income Tax Act 1952 except the said sum payable under this Deed".

H In any case, the payment was not to be less than £100. It is common ground that the nine payments in question were annual payments for the purposes of s. 169.

On 18th July 1957 the Company entered into an agreement with a company called Consolidated Investment Funds Ltd., to which I will refer as "C.I.F." Under that agreement the Company sold to C.I.F. the whole of the issued share

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capital in Aconite for £45,000, of which £100 was paid on completion. The agreement contained a provision that the balance was to be satisfied by payment to the Company, in each of the nine years ending 5th April 1958 to 5th April 1966, of a sum equal to the net profits of Aconite for each of the years ending 31st March 1958 to 31st March 1966. There was a proviso that if the aggregate of these sums exceeded £45,000 the purchase price should be increased by the excess.

It is common ground that the payments made by C.I.F. under this agreement were received by the Company as capital. The way in which the payments under the deed of covenant and the receipts under the agreement were recorded in the Company's books was this. An account was opened in the Company's ledger headed "Shares in Aconite Investments Ltd." On the debit side were entered payments to Aconite and on the credit side the capital receipts from C.I.F. During the relevant period, the payments made to Aconite were the full payments made in accordance with the deed of covenant, but the receipts from C.I.F. which were credited were not the full payments but payments on account of the amount due each year, equal in amount to the amount paid by the Company to Aconite. The result was that during the relevant period the ledger accounts exactly balanced, and because of this the transactions were not brought into the audited accounts except by way of notes on the balance sheets.

Mr. Clement, a member of the firm who were the Company's auditors, who gave evidence before the Special Commissioners and whose evidence was accepted, said that he regarded this as a natural and convenient way of dealing with the transactions, although there were other ways in which they might have been dealt with, but whichever way one chose, the amount available for distribution by way of dividend would remain the same.

I must now refer to the audited accounts for the relevant periods. For the year ended March 1958 the net profit of the Company, including balance brought forward, was £35,774. The Company paid dividends amounting net to £34,349, leaving £1,425 to be carried forward. During that year the net payment to Aconite was £25,225. For the year 1959 the figures were net profits, including balance brought forward, £26,727, net dividends, £24,500, balance carried forward, £2,227 and net payment to Aconite, £28,000. For 1960 the figures were net profits, including balance brought forward, £30,984, net dividends, £24,500, balance carried forward, £6,484 and net payments to Aconite, £27,500.

In relation to those figures, the Special Commissioners say this in the Case Stated([1]):

> "It is apparent from the above-mentioned figures that the Company had for each of the relevant years sufficient taxed profits to cover the annual payments to Aconite, but that it did not in each of those years, considered by itself, have sufficient taxed profits to cover these payments and also the dividends from which it deducted tax."

That is true, but what the Special Commissioners did not say was that there were accumulated taxed profits of £74,000 odd, out of which the dividends could have been paid.

([1]) *See* page 137, *ante*.

A So much for the facts. As I have said, the Special Commissioners dismissed the appeals against the assessments, but I need not refer to the reasons given by them for their decision as Mr. Bucher, for the Crown, did not seek to rely on their detailed reasoning. Mr. Bucher, as I understood the argument, submitted in effect two things: first of all, that the Company in its accounts had deliberately chosen to attribute the annual payments to Aconite to capital, B and cannot therefore now say they were paid out of profits brought into charge to tax; secondly, that the factual situation was such that the dividends and the annual payments could not both have been paid under deduction of tax out of profits brought into charge to tax, and therefore the annual payments must be attributed to capital.

Sir Andrew Clark's answer is to the effect that the Company's accounts C are a purely domestic matter which have nothing to do with the case, and the Company is entitled *ex post facto* to make whatever attribution it likes, and what it does like is to attribute the annual payments to the taxed profits of the relevant period and to attribute the dividends to the accumulated fund of taxed profits, augmented by the capital surplus arising from the agreement with C.I.F. He submits that on authority that is what the Company is entitled to do.

D The first case to which he referred was the decision of the Court of Appeal in *Allchin* v. *Coulthard*[1] [1942] 2 K.B. 228. The case went to the House of Lords, which confirmed the decision of the Court of Appeal and adopted unreservedly the judgment of Lord Greene M.R. in the Court of Appeal. The headnote to that case is this:

> "The phrase 'profits or gains brought into charge' as used in [rules] 19 E and 21 of the General Rules Applicable to All Schedules to the Income Tax Act, 1918"

—those rules are now ss. 169 and 170 of the Income Tax Act 1952—

> "does not indicate the cash resources out of which the payment of the interest is in fact made, but a fund in the accountancy sense of taxed profits up to but not exceeding the amount of the assessment ascertained for the F purpose of an account between the taxpayer and the revenue and deemed to be in his hands, to which the payment of the interest is to be debited. No profits which cannot be lawfully applied to the payment of the interest can be treated by the taxpayer as forming this fund or any part of it, but subject to this, apart from special circumstances, instances of which are provided by *Birmingham Corporation* v. *Inland Revenue Commissioners*[2] G [1930] A.C. 307 and *Central London Ry v. Inland Revenue Commissioners*[3] [1937] A.C. 77, the taxpayer is entitled to treat the interest as having been paid out of that fund, no matter out of what cash resources he in fact paid it. S. corporation paid out of their general rate fund, which consisted partly of untaxed income (namely, the rates collected) and partly of profits from its undertakings duly assessed to income tax, interest on H a loan raised for the purpose of their electricity and transport undertakings and general purposes, deducting income in the usual way. The corporation claimed, under the provisions of the South Shields Corporation Act, 1935, to treat the assessed profits of the electricity and transport undertakings

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([1]) 25 T.C. 445 (*sub nom.* Allchin *v.* Corporation of South Shields).

([2]) 15 T.C. 172. ([3]) 20 T.C. 102.

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as part of the assessed profits out of which the interest was paid and to retain the amount of tax paid on those profits:—*Held*, reversing the decision of Lawrence J., that by the provisions of the Act the profits of those undertakings could lawfully be applied to the payment of the interest on the whole of the loan, and, consequently, those profits as assessed to income tax formed part of the profits brought into charge out of which the interest was paid or deemed to be paid, notwithstanding that it appeared from the accounts of those undertakings, kept separately as required by the Act, that the surplus revenues of those undertakings had been treated as applied to certain specified purposes of those undertakings."

Then I must refer to a considerable part of the judgment of Lord Greene M.R., starting at page 233(1). He said this:

"The result down to this point is as follows. At the date when the interest was paid, the general rate fund was made up of moneys which in part were derived from untaxed income (rates) and in part from the profits of the undertakings for the year in question. Out of that fund the interest was paid. The profits of the undertakings for the year had been or would in due course be subjected to tax although the profits as assessed to tax would not be the same in amount as the actual profits shown by the accounts. They were in fact less. It is convenient here to refer to the tests laid down by Lord Atkinson in *Sugden's* case(2), which, in the Crown's contention, must be satisfied before the corporation can succeed. Lord Atkinson says that before the taxpayer can retain the tax deducted, he must be able to answer affirmatively two questions: (1.) Has the interest been in fact paid or must it in the circumstances of the case be taken to have been paid out of profits or gains brought into charge, i.e., out of the so-called 'taxed fund.' (2.) Was it lawful to pay them out of the fund? For the reasons which I have given I am of opinion that the second of these questions must be answered in the affirmative. It is in the case of local authorities that this question usually arises. The reason lies in the peculiar constitution of these bodies. Unlike the ordinary trading company, their income is in part derived from a source not liable to tax, i.e., rates. That part which is derived from their undertakings is taxable. The legislature has in the past imposed restrictions on the application of the profits of their undertakings, with the result that those profits had to be kept distinct from their other receipts, just as if a local authority had been several entities instead of one. Once those restrictions are removed, as in the present case, the authority ceases to be divided into separate compartments in this way and all its receipts become lawfully applicable for all its purposes. It is thus placed in precisely the same position in this respect as any other person.

It is on the first of Lord Atkinson's questions that the alternative contention of the Crown is based. It is said that when the accounts of the undertakings are examined it will be found that the profits which they earned in 1935–1936 were all in fact applied for the purposes of the undertakings themselves and that no part of them was in fact applied in payment of the interest with which we are concerned. This argument is, in my opinion, based on a misconception of the meaning of payment out of a taxed fund. On a previous occasion I ventured to point out some of the difficulties which

(1) 25 T.C., at p. 455. (2) 6 T.C. 211; [1914] A.C. 483.

A that and similar phrases appeared to me to occasion: *Fenton's Trustee* v. *Inland Revenue Commissioners*(1). That I had good ground for so doing appears from the opinion of Lord Macmillan delivered later in the same year in *Central London Railway* v. *Inland Revenue Commissioners*(2) in which the other members of the House of Lords concurred. Much of the obscurity which surrounds this matter is due to a failure to distinguish the two senses B in which the phrase 'payment out of a fund' may be used. The word 'fund' may mean actual cash resources of a particular kind (e.g. money in a drawer or a bank), or it may be a mere accountancy expression used to describe a particular category which a person uses in making up his accounts. The words 'payment out of' when used in connection with the word 'fund' in its first meaning connote actual payment, e.g. by taking money out of the C drawer or drawing a cheque on the bank. When used in connection with the word 'fund' in its second meaning they connote that, for the purposes of the account in which the fund finds a place, the payment is debited to that fund, an operation which, of course, has no relation to the actual method of payment or the particular cash resources out of which the payment is made. Thus, if a company makes a payment out of its reserve fund—an example D of the second meaning of the word 'fund'—the actual payment is made by cheque drawn on the company's banking account, the money in which may have been derived from a number of sources. The phrase 'reserve fund' only has a meaning as indicating the item in the company's accounts to which it decides to debit the payment. It will be seen, therefore, that to speak of an actual payment being made out of a fund in the second sense E is really a misuse of language. A fund in the second sense is merely an accountancy category. It has a real existence in that sense, but not in the sense that a real payment can be made out of it as distinct from being debited to it. Unless these two meanings of the phrase 'payment out of a fund' are kept distinct, much confusion of thought must ensue. A real payment cannot be made out of an imaginary fund: per Lord Macmillan F in the *Central London Railway* case(3).

In applying these considerations to the requirements of [rule] 21 that the interest must have been payable and paid out of profits brought into charge to tax, it will be seen that the word 'profits' cannot (except in the possible case of income taxed at the source) be construed as indicating the cash resources out of which the payment is in fact made. The word can G only be used in the accountancy sense of a fund of profits ascertained for the purposes of an account between the taxpayer and the revenue. As the result of taking that account the taxpayer is deemed to have in his hands a fund of taxed profits up to, but not exceeding, the amount of the assessment. Accordingly, it becomes necessary for the purpose of giving effect to [rules] 19 and 21 to draw up a further account as between the taxpayer H and the revenue. On the one side is entered the interest paid, and, on the other side, the 'taxed fund', which may consist of profits as assessed to tax under different schedules. The taxpayer is not entitled to bring in on this side of the account a taxed fund if the profits in respect of which the relevant assessment is made cannot lawfully be applied in the payment of the interest. Subject to this, in the absence of special circumstances to which I will refer

(1) 21 T.C. 626 (*sub nom.* Paton (as Fenton's Trustee) *v.* Commissioners of Inland Revenue); [1936] 2 K.B. 59. (2) 20 T.C. 102. (3) *Ibid.*, at p. 146.

(Plowman J.)

later, the taxpayer is, in my opinion, entitled to treat the interest entered on one side of the account as having been paid out of the items of taxed profit entered on the other side. In the accountancy sense, he has paid it, since as between him and the revenue he is entitled to have the account drawn in this way and to debit his payments to the taxed fund. It follows from this that (again apart from special circumstances) the question out of what cash resources was the payment made is entirely irrelevant. A trader may spend the whole of his profits for the year in buying himself a house, with the result that he has to borrow money to pay his mortgage interest. This does not disentitle him from saying that, as between himself and the revenue, he is entitled to debit the interest paid to the fund representing the amount in which his profits for the year are assessed. To hold otherwise would be to make nonsense of [rules] 19 and 21. Nor can the way in which, for his own convenience, he chooses to keep his accounts deprive him of this right. If he carries on two businesses and chooses to keep their accounts distinct, he may in those accounts show the profits of one business as having been wholly applied in buying capital assets for that business and charge the whole of the interest which he is liable to pay to, for example, a reserve account in the other business representing profits of past years, but, in taking the account as between himself and the revenue, he is entitled to treat the assessed profits of the first business as available for the payment of the interest. To speak of this as re-writing the trader's accounts is a misdescription. His domestic accounts stand, and there is no question of re-writing them. The account which is drawn up between himself and the revenue is a totally different account drawn up for totally different purposes and the figure representing taxed profits which appears in it is a statutory and (except in the case of profits taxed at source) not an actual figure.

I have thought it desirable to explain at some length the principles which appear to me to underlie questions of this nature. I might perhaps have contented myself with citing some of the passages in the numerous authorities in which the matter has been discussed, notably the speech of Lord Atkinson in *Sugden's* case(1), and that of Lord Macmillan in the *Central London Ry.* case(2), to which I have already referred, but the nature of some of the arguments presented to us showed that the subject is still regarded as wrapped in considerable obscurity and that must be my excuse. If I have correctly grasped these principles, it follows that, in the present case, the fact that the corporation in their domestic accounts have chosen, without any legal compulsion, to show the profits of their undertakings for the year as having been wholly applied for the purposes of the undertakings does not in any way disentitle them from saying that the interest has been or must be deemed to have been paid *pro tanto* out of the taxed fund at which these profits are quantified by assessment. Once it appears that the profits in respect of which the assessment is made are in their nature legally applicable for the purpose of paying the interest they are entitled to claim that it was in fact paid or must be deemed to have been paid out of those profits as assessed so far as they will go. They are in precisely the same position as the trader with two businesses to whom I have referred, the only difference being that part of their income, namely, that derived

(1) 6 T.C. 211. (2) 20 T.C. 102.

A from rates, is not liable to tax. This, however, does not entitle the Crown to say that the interest must be deemed to have been paid out of the rates. It is, in fact, as true to say that the rates have been applied for the purposes of the undertakings, leaving the profit available for payment of the interest."

I shall come back to the remainder of that judgment later on. In the House of Lords, Lord Simon L.C. said this([1]), [1943] A.C.607, at page 623, in relation B to the judgment of Lord Greene M.R. which I have been quoting:

> "I adopt in its entirety the exposition of the Master of the Rolls on this part of the case, in which he points out how limited is the assistance for the solution of this matter which can be derived from an examination of the way in which the corporation's accounts are made up and recorded."

Lord Macmillan, at page 626([2]), said:

C "On this part of the case I am so entirely content with the answer which the Master of the Rolls has given to the Crown's contention that I have nothing to add."

On the same page, Lord Romer said:

> "For I am satisfied for the reasons given by the Master of the Rolls, to which I cannot usefully add a single word, that the whole of the interest D on borrowed money paid by the corporation in the year 1935-1936 could properly be paid out of the profits or gains of the corporation for that year brought into charge to tax so far as such profits or gains were sufficient for the purpose, and that such interest ought, as between the corporation and the revenue, to be treated as having been so paid in fact."

While I am on this topic I should refer to one sentence from the speech of E Viscount Sumner in the *Birmingham Corporation* case([3]) [1930] A.C. 307, at page 318:

> ". . . but the decisions, I think, clearly contemplate that a mere attribution *ex post facto*, as part of a contention as to their rights, will serve the Corporation's turn without even an ultimate attribution in their books."

Those citations appear to me to show that there is a general rule which is F applicable to cases like the present, and this is that the taxpayer is entitled to say that annual payments made in any particular year are to be treated as having been paid out of his taxed income for that year to the extent to which such income is sufficient to pay them; and that his right to say this is unaffected both by the manner in which the payment has in fact been made and by the manner in which his domestic accounts have in fact been kept. But it appears that there G are two exceptions to this general rule: (1) where it would not be lawful for the taxpayer to make the annual payments out of the so-called taxed fund—no question of illegality arises in the present case; (2) where there are what has been called special circumstances.

I was referred to two cases of special circumstances. The first was the *Birmingham Corporation* case, which I have already mentioned. The headnote H there([4]) is this:

([1]) 25 T.C. 445, at p. 463. ([2]) *Ibid.*, at p. 465. ([3]) 15 T.C. 172, at p. 212.
([4]) [1930] A.C. 307

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"In 1920 the appellant Corporation undertook an Assisted Housing Scheme under the Housing, Town Planning, &c., Act, 1919, and for the purpose of the scheme borrowed money on local bonds secured on their rates, revenue and property. In each of the years ending April 5, 1922, 1923 and 1924, the separate account kept in respect of the scheme, as required by regulations under the Act of 1919, showed a loss due entirely to the need to pay interest on the local bonds. This loss was largely made good by an Exchequer subsidy, as provided by these regulations. The Corporation had one fund only, the borough fund, any deficiency on which was met by raising a borough rate. Into this fund the balance of profits of the Corporation's commercial activities was paid. During each of the three years the total taxed profits of the Corporation's property paid into the fund exceeded the aggregate amount of interest on loans payable by the Corporation, including the interest on loans under the Housing Scheme. In paying the interest on the local bonds the Corporation deducted income tax, but in the Housing Scheme account the gross amount of interest was charged as an element of loss. The question for determination was whether the appellant Corporation was liable to account to the Crown for the tax so deducted under [rule] 21 of the All Schedules Rules of the Income Tax Act, 1918. The Crown contended that the Exchequer subsidy must be regarded as having been applied for the purpose, so that to that extent the interest was paid out of money not already brought into charge, but the Corporation contended that the interest must be treated as paid out of profits and gains forming part of the borough fund which had already been brought into charge, and that the Exchequer subsidy only went to recoup the borough fund: *Held*"

—and I read this without pausing to consider whether it accurately represents the decision—

"that in so far as the taxed income of the Housing Scheme was insufficient to meet the interest on the loans, the interest was not payable, or was not in fact paid, out of profits and gains brought into charge to income tax, and therefore the appellants were bound to account to the Crown for the sum deducted for tax."

The *ratio decidendi* of that case, so far as the question of special circumstances was concerned, was stated by Lord Buckmaster, at page 313([1]), in this way:

"The Corporation by the accounts put forward for the purpose of obtaining and measuring the subsidy represented that the sum required for interest was the gross sum. If the interest was paid out of moneys already taxed this was not the sum required; they only required the lower figure. The statement therefore was equivalent to saying that the interest had not been paid out of moneys which had already paid tax. They cannot therefore now set up the contrary, but, if not so paid, the tax is still undischarged and it is in their hands for payment."

At page 320([2]), Lord Atkin said this:

"As it was lawful for them to pay out of their taxed funds, so it was lawful for them to pay out of their untaxed funds. In both cases they must

([1]) 15 T.C. 172, at p. 209. ([2]) *Ibid.*, at p. 214.

A deduct the income tax; in the former case they could put it in their pocket, in the latter case they must account to the Crown. In the former case their loss caused by payment of interest would be limited to the net amount paid; in the latter case it would extend to the full amount. But in preparing the account for the subsidy under the regulations they return the amount required for interest as the full amount without deduction; and they give B no credit for and make no reference to the deduction. The account is prepared for the purpose of ascertaining the loss on the Housing Scheme, and in these circumstances it must, I think, be taken that the Corporation are representing that they are out of pocket the full amount of the interest, or, in other words, that they have no right to keep for themselves the income tax deducted. This can only be on the footing that they have in fact paid C the interest out of their untaxed funds. I do not think that it is necessary to involve the principles of estoppel, even if the necessary conditions for an estoppel exist, as to which I say nothing. The effect of the form of the account, charging the gross amount of interest as an element of loss intended to result in receipt of a subsidy and followed by the actual receipt of the money based upon the representations contained in it, is to afford D to my mind conclusive proof that the Corporation in fact paid the interest out of untaxed funds. If so, the assessments in question were correctly made."

The second case of special circumstances was the *Central London Railway* case(1) [1937] A.C. 77. The headnote is as follows:

"In 1930 a Railway Company was empowered to raise £850,000 of E additional capital by means of an issue of 5 per cent. redeemable debenture stock, and was authorised for five years to charge to capital account the interest accruing on all money raised thereby. In the year ending on December 31, 1930, the Company paid interest amounting to £4,250 to holders of this stock. Of that sum, £2,340 1*s.* 11*d.* was charged to capital account and £1,909 18*s.* 1*d.* to revenue account. On paying the £4,250 to F the holders of the new debenture stock the Company deducted income tax thereon and claimed to retain for their own purposes the amount so deducted:—*Held*, that the sum of £2,340 1*s.* 11*d.* had not been brought into charge to tax within the meaning of Rules 19 and 21 of the All Schedules Rules and that the Company could not retain the amount deducted from that sum."

G The leading speech was delivered by Lord Macmillan and I refer to what he said, starting at page 88(2):

"I now come to the special circumstances of the case in hand. Accepting the position that in the year in which the interest in question was paid there were 'profits or gains' of the Railway Company 'brought into charge to tax', in the sense of income assessed and charged to tax in that year, in H excess of the amount of interest paid, there remains the question whether the interest was 'payable' out of these 'profits or gains'?"

and then he deals with the meaning of the word "payable" on page 89. Then he continues:

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(1) 20 T.C. 102. (2) 20 T.C., at p. 151.

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"Now it is true that the Railway Company could lawfully, if they chose, have paid the interest in question out of their profits, and it is also true that the interest was paid out of a general banking account which contained sufficient profits (though these profits were not their assessed profits—a difficulty which still haunts me). But the interest was actually paid out of capital, and capital was the real source of payment. If the debiting of the interest were merely a matter of domestic accounting I should not be disposed to lay much stress upon it. But in my opinion it was much more than this. There was a deliberate decision to charge the sum in question against capital and not against revenue. That being so, I do not see how the Railway Company can claim to retain the tax on this interest paid out of capital when the right to retain tax is conditional on the interest being payable out of profits. If the interest had been paid out of actual profits the sum so paid would have figured in the Railway Company's return of profits to be charged to tax in the next year; but the £2,340 1*s.* 11*d.* has never appeared and will never appear in any return by the Railway Company for tax purposes, for it is a payment out of capital. Consequently the Crown will never receive any tax either from the Railway Company or from the debenture holders in respect of the interest paid to the latter in 1930 if the Railway Company are not held accountable to the Crown for the tax which they deducted. The theory of the notional taxed fund covering the amount of the interest paid does not fit such a case, for the transaction is outside the region of profits whether notional or actual. By their own deliberate act the Railway Company have made this sum not payable out of profits. It is nothing to the purpose that theoretically the Railway Company might in some future year carry this sum of £2,340 1*s.* 11*d.* back into profit and loss account as income. As to whether in the circumstances they could competently do so I express no opinion. But in the tax year in question they have chosen not to debit this sum to revenue account, and consequently have pro tanto prevented the diminution of the dividend fund in the distribution of which among their shareholders they have deducted tax and, as they were entitled to do, have retained the tax deducted.

My Lords, I do not think that the same sum can be utilised by the Railway Company to render them those two inconsistent services in the same tax year, so as to entitle them first to attribute the £2,340 1*s.* 11*d.* to the payment of interest to their creditors and claim to retain the tax deducted therefrom as if it were paid out of revenue, and then, by debiting it to capital, to enhance the dividend fund and claim to retain the tax deducted from their shareholders on paying them their dividends. Whatever view be taken of the meaning of Rule 19 I do not think that the Railway Company can bring such a case within it."

In *Allchin* v. *Coulthard*(1), [1942] 2 K.B. 228, at page 237, Lord Greene M.R. had this to say in relation to those two cases:

"I have referred to the fact that special circumstances may exist which will provide a different result. I do so by reason particularly of two decisions on which counsel for the Crown placed great reliance. In my opinion, however, they have nothing to do with the present case. The circumstances in each case were very special. In the *Central London Ry.* case(2), the railway

(1) 25 T.C. 445, at p. 457. (2) 20 T.C. 102.

company had statutory powers to do what it would not have been entitled to do, namely, charge the interest on certain debenture stock to capital. This power it elected to exercise. The figure at which its profits were assessed to tax was large enough to cover the interest and it claimed to be entitled to treat the interest as having been paid out of those profits. It was held that it was not entitled to do so. Now, the fact that the company chose to charge the interest to capital might at first sight appear to be a mere matter of domestic accountancy. Had it charged the interest to revenue, as it was perfectly entitled to do, it could unquestionably have retained the tax, but by taking the course which it did it set the amount of its profits free for payment of dividend. Its action, as Lord Macmillan said([1]), was much more than a mere matter of domestic accountancy. He went on to explain why this was so. The effect of charging the interest to capital was to swell the dividend fund on the distribution of which the company retained a larger amount of tax than they would have retained if the interest had been charged to revenue and the dividend fund in consequence reduced. They could not at one and the same time claim to enjoy this larger retention and treat the interest as chargeable, as between themselves and the Crown, to revenue account. The other case is *Birmingham Corporation* v. *Inland Revenue Commissioners*([2]). There the corporation's expenditure on a housing scheme, including interest on loans raised for the purposes of the scheme, exceeded the receipts and the corporation claimed to treat the interest on the loans as having been paid out of its taxed income. For the purpose of claiming the exchequer subsidy, the interest paid on the housing loan was brought in by the corporation at the gross and not the net figure. Lord Buckmaster pointed out that 'The accounts were prepared for a department of the Crown to whom, acting through another department, the tax was payable, and so regarded were prepared upon the footing that the tax was unpaid, with the result that either the creditor was still liable for the tax or that, if it had been deducted, it was retained to satisfy his liability in that respect.' The decision turned entirely on the special nature of the exchequer subsidy and the action of the corporation in basing its claim for subsidy on the assertion that it was out of pocket to the extent of the gross amount of the interest."

In the House of Lords in the *Allchin* case([3]) [1943] A.C. 607, at page 623, Lord Simon L.C. had this to say about the *Birmingham Corporation* case:

> "The result is that there would be nothing illegal in the corporation paying this interest out of the mixed fund which contains its profits or gains. Neither is there anything in the present case which goes to show that they have precluded themselves by inconsistent action (as was the case in *Birmingham Corporation* v. *Inland Revenue Commissioners*) from being treated as paying the interest out of profits or gains brought into charge."

At page 625([4]), Lord Macmillan said this:

> "This brings me to the last point which is the point expressly raised in the present case. The figure at which the taxpayer's profits for the year have been assessed and on which he has paid tax having been ascertained, is that figure further examinable? The Crown contends, and the authorities

([1]) 20 T.C. 102, at p. 143. ([2]) 15 T.C. 172. ([3]) 25 T.C. 445, at p. 463.
([4]) *Ibid.*, at p. 464.

(Plowman J.)

justify the contention, that it is, and that the taxpayer cannot be deemed to have paid interest out of profits which cannot legally be applied in payment of that interest or which he has by his own deliberate actings debarred himself from so applying." A

Then, just a little further down the page:

"If an ingredient of the profits as assessed is derived from a source which precludes the application of that ingredient to the payment of interest on borrowed money" B

—that is the illegality point—

"or with regard to which the taxpayer has so acted as to preclude himself from being deemed to have so applied it, then to that extent I think that the taxpayer is debarred from saying that he has paid the interest in question out of profits or gains brought into charge to tax." C

It appears, therefore, that the *Birmingham Corporation* case([1]) turned on the point that the Corporation, having represented to the Exchequer, in order to get a larger subsidy, that interest had not been paid on moneys which had already borne tax, was not entitled to maintain the contrary to the Revenue. There are no comparable circumstances in the present case. The *Central London* case([2]) turned on the point that the company, by charging the debenture interest to capital, which it could not have done without statutory authority, set free an equivalent amount of its profits for payment of dividend, and the Court of Appeal and the House of Lords held that the company could not at the same time claim to retain tax on this increase and treat the interest as chargeable to revenue account. But in the present case the amount of the dividend fund remains the same, whether the annual payments are made out of the fund of accumulated profits or out of the capital surplus which could have been made available for payment of dividends. D E

What, then, is the result? In my judgment Sir Andrew Clark is right in submitting that the only circumstances which are special circumstances, within the authorities to which I have referred, are cases where the taxpayer has elected to attribute annual payments or interest to capital in order thereby to gain some tax or other fiscal advantage, and so is precluded from contending that they were made out of taxed income. In the present case it does not seem to me that the Company gained any fiscal advantage by the way the annual payments were treated in the ledger account, and therefore in my judgment the case falls within the general rule and not within any exception to it. That being so, the Company is, in my judgment, entitled to say this to the Revenue: We propose to treat the receipts from C.I.F. as having been brought into the profit and loss account and so available for payment of the dividends which were paid during the relevant period. The accumulated fund of taxed profits is amply sufficient to frank those dividends, and therefore we treat the taxed profits for the years in question as a source of the annual payments for those years. F G

Mr. Bucher summarised his argument in the form of six propositions. (1) That all the authorities march together; so much is common ground, but the dispute is as to where they lead. (2) That where there is a mixed fund and the taxpayer's treatment of it is neutral, the annual payments can be attributed to H

([1]) 15 T.C. 172. ([2]) 20 T.C. 102.

taxed profits; Sir Andrew Clark concurs with that proposition so far as it goes, but he submits that it does not go far enough. (3) That where there is a mixed fund and the taxpayer has deliberately chosen to attribute the annual payments or interest to capital, he cannot afterwards say that the annual payments or interest are payable out of profits; Sir Andrew Clark submitted that this proposition required to be qualified by limiting its application to a case where the choice had been made for the specific purpose of gaining a fiscal advantage, and, as I have already indicated, this submission is, in my view, on the authorities, correct. (4) That proposition (3) stands whether or not the attribution of annual payments and profits is incompatible with the payment of dividends; this is accepted by Sir Andrew Clark, subject to the qualification of proposition (3) to which I have referred. (5) That in the present case the dividends and annual payments could not both have been paid under deduction of tax out of profits brought into charge to tax; Sir Andrew Clark answers that this is wrong because the capital surplus could have been transferred to profit and loss account, enabling them both to be paid under deduction of tax out of profits brought into charge; I have already indicated that I think that this is so. (6) That the Special Commissioners were right to say, first, that the factual situation makes payment of the annual payments out of taxed profits impossible, and, secondly, that the Company's deliberate accounting precludes them from attributing the annual payments to profits; the answer to this is the same as the answer to proposition (5); the only deliberate accounting was for domestic purposes and not for tax purposes.

Mr. Stamp added an argument for the Crown based on the impossibility of getting a quart out of a pint pot, but, as I have already tried to indicate, the answer in my view is that it is open to the Company *ex post facto* to increase the size of the pot. For these reasons I allow the appeal and discharge the assessment.

Nolan—Would your Lordship say that the appeal is allowed with costs?

Plowman J.—That would be right, Mr. Bucher?

Bucher Q.C.—I cannot resist that, my Lord. I think, perhaps, your Lordship ought to add that the assessment ought to be discharged.

Plowman J.—I thought I did say that.

Bucher Q.C.—I am sorry; I am not abreast of events.

The Crown having appealed against the above decision, the case came before the Court of Appeal (Harman, Danckwerts and Salmon L.JJ.) on 21st, 22nd, 23rd, 26th, 27th and 28th October 1964, when judgment was reserved. On 26th November 1964 judgment was given in favour of the Crown, with costs.

H. H. Monroe Q.C., *J. Raymond Phillips* and *J. P. Warner* for the Crown.

Sir Andrew Clark Q.C., *M. P. Nolan* and *J. Holroyd Pearce* for the Company.

Harman L.J.—I am authorised by **Salmon L.J.** to say that he concurs with the judgment I am about to deliver. A

This appeal is concerned with those annual payments which are dealt with by ss. 169 and 170 of the Income Tax Act 1952, re-enacting the old General Rules 19 and 21 of the Rules applicable to all Schedules of the Income Tax Act 1918. Section 169 provides that, where any annual payment is payable wholly out of profits or gains brought into charge to tax, the payer is to be charged with B the tax, and may on making the payment deduct and retain a sum representing the amount of the tax at the standard rate for the year in which the amount payable became due. The payee is bound to suffer this, and the payer is discharged of the sum represented by the deduction as if he had actually made it. Under s. 170, where any such annual payment is not payable out of profits or gains brought into charge, the payer *must* on making payment deduct the amount of C the tax and account for it to the Crown. The question here is whether the Respondent Company (which I shall call "the Company"), having made deductions on making certain annual payments, is entitled to retain them under s. 169 on the footing that the payments have been made out of moneys brought into charge or must, as the Crown claims, account for them under s. 170. The Special Commissioners held the Company accountable. The Judge reversed D that decision. The Crown appeals.

Most of the transactions with which this case is concerned have for me an air of total unreality. The several companies which come and go seem mere lay figures, dummies set up as payers or receivers of large sums of money for no apparent commercial purpose, though I can only suppose for some end concerned with taxation. No explanations were offered to the Special Com- E missioners, nor to us, of the object or effect of these transactions, which I confess to finding incomprehensible. I will state the facts so far as I can follow them. The Company was incorporated in the year 1951 and carries on a fairly extensive business as shipbrokers. It had an issued share capital of rather over £17,000, and made considerable profits year by year out of which small dividends were paid in 1953, 1954 and 1955. All the shares in the Company were in August F 1955 sold to a company called Avenue Finance Co. Ltd., but at what price is not stated. In 1957, the Company, in the hands of its new owner, paid a dividend of £269,565 gross or £155,000 net. There remained to the credit of the profit and loss account a balance of £4,449. The Company, as its balance sheet shows, had some modest further assets, and immediately after the payment of the dividend Avenue Finance Co. Ltd sold the whole of its shares in the Company G to Fashion & General Investment Ltd. for about £17,000. Shortly afterwards, in the hands of its new master, the Company promoted a company called Aconite Investments Ltd., with an authorised share capital of £100 and two £1 shares issued to the Company for cash. Whether Aconite had any business or any assets is not apparent.

Two months later, on 12th July 1957, the Company entered into a deed by H which it covenanted to purchase the 98 shares in its own wholly-owned subsidiary, Aconite, at a price to be measured by the annual income arising year by year over the years 1957–58 to 1965–66 inclusive, on certain of the Company's shipbroking contracts set out in a schedule to the deed, which provided that the covenanted sums should rank as annual income payments from which income tax should be deducted. A week later the Company, in order, presum- I ably, to finance its payments to Aconite under the deed of covenant, sold all its Aconite shares to a company called Consolidated Investment Funds Ltd. for a sum of £45,000. This sum was to be paid by instalments equal to Aconite's

net profits for the financial years 1958 to 1966 inclusive, but if the profits in question exceeded £45,000 the price was to be increased by that excess. In other words, all Aconite's net profits for the years in question were to be absorbed in paying for its shares. The agreement also provided that the payments by Consolidated Investment Funds Ltd. were to be paid to and received by the Company as capital sums on account of the purchase price of the Aconite shares. There does not seem to have been any point in these two agreements, which were apparently designed to produce a balance, and were in fact omitted from the balance sheets of the Company, except for a note which stated that no material surplus or deficiency was expected from the transactions.

It will be remembered that the payments to Aconite under the deed of covenant were expressed to be income payments, whereas the payments by Consolidated Investment Funds Ltd. for the Aconite shares were expressed to be instalments of a capital sum. Apart from the notes on the balance sheets which I have already mentioned, the only evidence about these two transactions is to be found in the ledger on one page headed "Shares in Aconite Investments Limited". There the two transactions are shown as balancing transactions and this is consistent with the notes in the balance sheets. On one side of the page are shown the covenanted payments by the Company to Aconite, and against them are set the instalment payments to the Company by Consolidated Investment Funds Ltd. That is to say that the books indicated that the two transactions were related and the Company's income obligations are shown as satisfied by the application of the capital sums received. If this be the true view, then the annual payments were made out of capital sums not brought into charge to tax, and this is the case for the Crown.

The net payments to Aconite were: 1958, £25,225; 1959, £27,097; 1960, £26,539. These payments were made under deduction of tax, the sums deducted being: 1958, £18,644 15*s.*; 1959, £20,028 11*s.*; 1960, £16,789 19*s.* 9*d.* These latter sums the Company claims to keep in its pocket, while the Revenue claims that they are, as the books show them to be, sums deducted out of receipts not brought into charge to tax and must be accounted for accordingly. On 22nd May 1958 the directors submitted their report and accounts for the year ending 31st March 1958. From these it appears that the net profit for the year was £26,725. Adding to this the balance already mentioned to the credit of the profit and loss account carried forward from the previous year—£4,449—and a sum of £4,600, being his remuneration waived by the managing director, there is a total for the year of £35,774. Out of this dividends amounting to £34,349 were recommended and paid, leaving a balance to carry forward of £1,425. From the like sources for 1959 it appears that net profits amounted to £26,727, net dividends to £24,500, balance carried forward, £2,227. For 1960 the figures were, profits £30,984, dividends, £24,500, balance carried forward, £6,484.

It is obvious that both sets of payments could not be made out of the current profits. It is well settled that, where a company or an individual is in receipt in any year of sufficient assessable profits, these may be treated as available in ordinary circumstances to pay annual sums, and this entitles the company to deduct tax on making the payments, and that this is so even though as a matter of bookkeeping the company is shown as making the payments out of capital. The principle goes back at any rate to *Sugden* v. *Leeds Corporation*[1] [1914] A.C. 483, and is best explained, perhaps, in the judgment of Lord Greene M.R. in *Allchin* v. *Coulthard*[2] [1942] 2 K.B. 228, a judgment fully approved

(1) 6 T.C. 211. (2) 25 T.C. 445 (*sub nom.* Allchin *v.* Corporation of South Shields).

(Harman L.J.)

in the House of Lords, [1943] A.C. 607. In that case([1]) Lord Greene M.R. showed very clearly that, for the purpose of showing the source from which the taxpayer makes annual payments, the way in which he keeps his accounts is irrelevant. If during the year in question he has made profits, the fact that in his published accounts he has shown those profits as absorbed for other purposes does not prevent him as against the Crown from pointing to those profits as profits brought into charge to tax and so entitling him to retain the tax deducted under s. 169. The principle so luminously explained by Lord Greene M.R. is easy to follow if one considers the case of a private person, who may deduct and retain income tax on annual payments which he makes, even though he has in the year in question used up all his income for capital purposes. He need not, of course, keep any accounts at all, and has only to show that in the year in question there were taxed profits in his hands to entitle him to make the deduction. Limited companies, on the other hand, have to keep accounts, but I do not see that for this purpose they need actually rewrite the accounts. It will be enough to show that the taxed profits in fact existed for the relevant period: see the speech of Lord Sumner in *Birmingham Corporation* v. *Commissioners of Inland Revenue*([2]) (1930) 15 T.C. 172, at page 212.

In the present case it has been sought to extend the principle to the case of dividends: it is said that the Company is entitled to go back, however far into the past, to find some year in which there were assessed profits (whatever the rate of assessment) and that these are available unless already paid away in dividends to "frank", as the Judge called it, the dividend in question. There is no authority for this proposition. It is an analogy said to follow from the principles enunciated by Lord Greene M.R., but I do not myself think the analogy a true one.

For the purpose of his presentation of the argument Sir Andrew Clark, for the taxpayer, relied entirely on document H([3]) attached to the Case. This purports to show the assessed income of the Company in each of its trading years from 1952 onwards. Thus, in 1957 the accumulated total of taxed income is shown as £376,609 and the gross dividends paid up to that date as £302,421: hence the £74,000 odd mentioned by the Judge. I do not find this document convincing, or indeed relevant. It bears no relation at all to the Company's balance sheets and profit and loss accounts. No such figure as £74,000 accumulated balance of dividends is to be found in its accounts at all, nor any asset which could represent that sum. It will be remembered that the balance on profit and loss account after the very large dividend had been paid in 1957 was rather over £4,000, and the whole of the assets of the Company were then sold for £17,000 or so. This would be strange indeed if there were in existence in fact an accumulated profit of £74,000. Document H seems to take no account of payments by the Company by way of taxation. In fact document H seems to me as unreal as most of the other documents in this case.

The argument as I understand it is something as follows. Both the payments of the dividends and the payments of the annual sums as shown in the books are mere matters of bookkeeping and irrelevant so far as the Crown is concerned. The books can be rewritten for taxation purposes to show the annual payments made out of profits, there being sufficient profits in each year to make them, as is the fact, while the dividends can be treated as though paid out of the

([1]) 25 T.C. 445, at p. 452. ([2]) [1930] A.C. 307, at p. 314. ([3]) *See* page 142, *ante*.

A accumulated balance of taxed profits remaining over from previous years, and thus exempt from tax. Like the Special Commissioners, I am unable to accept this. I agree at once that in the ordinary case the annual profits can be treated as available for the annual payments, but I do not see how the dividends, which were stated by the directors to have been paid out of those very annual profits, can now be said to have been paid out of something else. In the first place, I B do not find by looking at the accounts of the Company that there was in fact a hidden reserve of some sort from which the dividends could be paid. Secondly, where a company has resolved to pay a dividend out of certain profits and has acted on that resolution, I know of no authority which entitles it thereafter to claim that it was not payable out of those profits at all but out of some other fund. This does not seem to me to follow from the cases cited.

C Apart from this, if the dividends were to be supposedly paid out of past accumulated profits, they would seem to be payments made out of capital sources, and so to treat them would alter the rights of the recipients, who would be receiving a capital dividend and not an income dividend. If then the Company has elected to pay these dividends out of its annual profits, it must abide by that election and cannot now seek to attribute the same profits to a different D purpose, namely, the payment of the annual sums to Aconite. I find myself in agreement with the Special Commissioners in the view they take that there is no evidence to show that the Company ever did have recourse to an accumulated balance of taxed funds, and that as a matter of fact they did not do so and cannot now be heard to say that they did.

The Company's argument is that so far as dividends go this too is a mere E matter of bookkeeping and the principle of *Allchin* v. *Coulthard*[1] can be extended so as to apply to dividends. True it is, say the Company, that according to our books the dividends were paid out of current profits, whereas the annual payments were made out of current capital receipts, but both are mere matters of bookkeeping and are irrelevant as between us and the Crown. Like the Commissioners, I find myself unable to accept this argument. It is still true to F say, as Lord Atkin did in the *Birmingham Corporation* case, 15 T.C., at page 213, that the first question remains: were the payments in question in fact made out of profits brought into charge? It seems to me that the Company, having declared dividends out of its taxed profits for the year in question, and having paid them as if made out of those profits, that is to say, under deduction of tax, cannot be heard to say that the dividends were not so paid. The decision G to pay out of taxed profits of the year made a difference to the position of the recipients of the dividends, for if these had been paid not out of income profits but out of capital profits, such as were the receipts by way of instalment, the Company could not lawfully have deducted the tax, nor could recipients who were entitled to return of tax have made claim for such returns.

Central London Railway Co. v. *Commissioners of Inland Revenue*[2] 20 T.C. H 102 seems relevant in this connection. There Romer L.J. said this (at page 141):

> "I do venture to say this, that, where, not for the purposes of convenience or for the purposes of giving effect to the payer's own notions of account keeping, but for the purpose of definitely deciding and of recording the fact that a decision has been come to that a certain payment of interest

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(1) 25 T.C. 445. (2) [1937] A.C. 77.

(Harman L.J.)

is to be paid out of capital and not out of interest, then the account is not only of great importance but, in the absence of evidence to the contrary, is conclusive upon the matter."

It was argued that the only exception from the ordinary rule that a company may rewrite its accounts for tax purposes was where the company was obtaining some fiscal advantage from so doing. This was accepted by the Judge and formed the basis of his decision. No doubt the fact of a fiscal advantage being obtained is a bar, but I do not think it is the only one. I do not regard the Company's expedient as legitimate. The annual payments here could not on the facts of the case have been paid out of past accumulations of profits, because on the facts of the case they did not exist; they were a mere fiction and no rewriting of the accounts would have provided them. The cases show that where there are current profits the annual payments can be taken to have been paid out of them, but I find no warrant for saying that this can be extended so as to pretend that dividends in fact paid out of current profits could have been treated as not so paid by restoring to surplus profits of past years, even if these exist, and I find in this case that they do not. In these circumstances I would allow the appeal and restore the finding of the Commissioners.

Danckwerts L.J.—I agree with the judgment delivered by Harman L.J. As Harman L.J. has stated, the principles which apply to this case were explained by Lord Greene M.R. in *Allchin* v. *Corporation of South Shields* (1942) 25 T.C. 445, in a judgment which received the approval of the House of Lords, and must be taken to express the law on this subject. The position is explained fully by Lord Greene M.R., at pages 456–7.

I would call attention to the example which Lord Greene M.R. gives on page 456, which is that of a company. It is clear, therefore, that Lord Greene M.R. considered that the principles which he laid down applied as much to a company as to an individual person dealing with his own business. It seems to me that this must be so, and I fail to see why a resolution of the directors of the company has any more irrevocable effect than the decision of an individual to make a particular payment out of moneys which have reached his bank account from a particular source. Individuals and companies alike pay their debts out of whatever is the convenient asset available for the moment. The only difference is that the directors usually pass a resolution as to the payment. Then the matter passes into the hands of the accountants to show the payment against the appropriate fund in the final settlement of the accounts.

Lord Greene M.R. plainly considers that in making up the accounts between the taxpayer and the Inland Revenue the funds which have already been brought into charge for purposes of income tax may be utilised in such accounts however the allocation may have been shown for other purposes. This is the ordinary rule, though special circumstances may produce a different result. Lord Greene M.R. treats *Corporation of Birmingham* v. *Commissioners of Inland Revenue*(1) and the *Central London Railway* case(2) as special cases, and Lord Macmillan (who made the leading speech in the last-mentioned case) in *Allchin's* case accepts the principles stated by Lord Greene M.R. as correct. It must be accepted, I think, that there is, therefore, no conflict between these cases. But it must be possible to apply the rule without using the income already

(1) 15 T.C. 172. (2) 20 T.C. 102.

charged to tax twice over. This is the part of the case which presents the most difficulty. Harman L.J. has analysed the facts and the evidence in the present case and I do not need to repeat the process. I agree with the conclusion which he has reached that it is impossible for the Company to show that the sums of income subjected to tax were available to pay the annual sums in the present case. I agree, therefore, that the appeal should be allowed.

Warner—Will your Lordships order that the Order of the Chancery Division be set aside and the assessments made by the Special Commissioners restored?

Harman L.J.—That sounds to me right.

Nolan—I respectfully agree, my Lord.

Harman L.J.—Does the taxpayer agree with that?

Nolan—Yes, my Lord.

Warner—My Lord, I ask that the taxpayer should pay the Crown's costs in this Court and in the Court below.

Harman L.J.—Here and below?

Warner—Yes, my Lord.

Harman L.J.—Yes.

Nolan—My Lord, may my client have leave to appeal to the House of Lords?

Harman L.J.—Very well, leave is given.

The Company having appealed against the above decision, the case came before the House of Lords (Lords Reid, Morris of Borth-y-Gest, Upjohn, Wilberforce and Pearson) on 14th, 18th, 20th and 21st October 1965, when judgment was reserved. On 15th December 1965 judgment was given in favour of the Crown, with costs.

F. Heyworth Talbot Q.C., *M. P. Nolan* and *J. Holroyd Pearce* for the Company.

H. H. Monroe Q.C., *J. Raymond Phillips* and *J. P. Warner* for the Crown.

Lord Reid—My Lords, this House has decided the case of *Chancery Lane Safe Deposit and Offices Co. Ltd.* v. *Commissioners of Inland Revenue*[1] in favour of the Crown, and it appears to me necessarily to follow that the present appeal must fail. Even on the view which commended itself to me in the *Chancery Lane* case, I would have thought that the present appeal must fail, but no good purpose would be served by setting out my reasons for making the difference.

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[1] Page 83, *ante*; [1966] A.C. 85.

(Lord Reid)

Two arguments submitted for the Appellants in the present case did not enter into the *Chancery Lane* case. The first was based on exhibit H, which purported to show accumulated taxed profits out of which the dividends could have been paid, and the second arose out of some observations of Lord Radcliffe in *Commissioners of Inland Revenue* v. *Frere*(1) [1965] A.C. 402. For the reasons given by my noble and learned friend Lord Wilberforce, I am of opinion that neither of these arguments can succeed. I would therefore dismiss this appeal.

Lord Morris of Borth-y-Gest—My Lords, the transactions which gave rise to this case, which, as Harman L.J. observed, seem to have an air of total unreality, are carefully recounted in the Case Stated. The agreements that were entered into had the result that the Appellants (the Company) were to receive from Consolidated Investment Funds Ltd., as capital payments, yearly amounts which for all practical purposes were equal to the yearly payments which the Company had covenanted to pay to Aconite Investments Ltd. The assessments of which the Company complained, and which had been made under s. 170 of the Income Tax Act 1952, related to the three years 1957–58, 1958–59 and 1959–60. The assessments were in the sums of the annual payments under the deed of covenant. They were the sums for the respective years of £43,870, £47,126 and £43,329. In making the annual payments the Company had deducted tax. If the payments were "payable wholly out of profits or gains brought into charge to tax" then it followed (pursuant to s. 169) that the Company could retain the tax deducted; if the payments were not so payable or not wholly so payable then it followed (pursuant to s. 170) that the Company was assessable.

The general rule as to the taxpayer's ability to attribute an annual payment was considered in *Central London Railway Co.* v. *Commissioners of Inland Revenue*(2) 20 T.C. 102, and in *Allchin* v. *Corporation of South Shields*(3) 25 T.C. 445. In the latter case Viscount Simon L.C., at page 463, stated the general rule as being that:

> "annual payments paid in a particular year, which, if the profits or gains brought into charge for that year were large enough, would have been properly payable thereout, are to be treated as having notionally been paid out of the payer's assessed income for that year, and the payer is to be allowed to deduct and retain the tax on the annual payments, provided that the amount so deducted and retained does not exceed the amount of tax payable by him in that year on his assessed income. Any such excess he may not retain but he must account for it to the Crown."

It might be, however, that taxpayers have "precluded themselves by inconsistent action".

In the present case the Special Commissioners came to the conclusion that the annual payments were made entirely out of capital. The Company used its capital receipts to make its annual payments. Evidence was before the Commissioners as to the dividends paid by the Company. For the three years ending 5th April 1958, 1959 and 1960, the figures appear to have been as follows:

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(1) 42 T.C. 125. (2) [1937] A.C. 77. (3) [1943] A.C. 607.

	Year ending 5th April		
	1958	1959	1960
	£	£	£
Profits and gains brought into charge ..	116,979	49,070	50,193
Annual payments under covenant (gross)	43,870	47,126	43,329
Dividends (gross)	15,737	44,000	40,000

It is manifest that in some years at least the Company did not have taxed profits greater in amount than the total of its annual payments and the dividends from which it deducted tax. It was the submission of the Company that the annual payments could be attributed to the taxed income, and that the question as to the tax position in regard to the dividend payments that were made need not now arise or be decided. It was also submitted that if the annual payments are attributed to the taxed income the payment of dividends with deduction of tax was warranted because there was a cumulative balance of taxed income which overtopped the cumulative total of gross dividends paid: there was, it was said, at 5th April 1957 a cumulative balance of taxed income of £376,609 whereas the cumulative total of gross dividends paid was £302,421: there was therefore, it was said, a balance of over £74,000 to enable dividends to be "franked" for tax deduction. So also it was said that for the next three years there was a cumulative balance of taxed income less annual payments which overtopped the cumulative figure of gross dividends paid.

My Lords, these figures are in any event somewhat unreal. As Harman L.J. pointed out, no such figure as £74,000 accumulated balance is to be found in the accounts nor any asset which could represent that sum. The £74,000 did not exist in the form of resources capable of being drawn upon or distributed.

My Lords, in my view the present case is governed by the decision in *Central London Railway Co.* v. *Commissioners of Inland Revenue* 20 T.C. 102. I need not here repeat what I have endeavoured to say in *Chancery Lane Safe Deposit and Offices Co. Ltd.* v. *Commissioners of Inland Revenue*[1] as to the principles laid down in the *Central London Railway* case. The facts in the present case show that there was a clear decision to make the annual payments out of capital. That decision was maintained and was acted upon year after year. The decision of the Special Commissioners that the annual payments were in fact made out of capital was one that was manifestly supported by the evidence. The Company so acted as to preclude themselves from attributing the annual payments to the taxed profits. This was not a matter of method of account-keeping or book-keeping. Though the figure of profits or gains brought into charge to tax is a notional figure, it is to be remembered that when annual payments are made or when tax is paid or when dividends are paid there have to be actual payments out of some actual fund or source of payment. In the profit and loss and appropriation accounts of the Company for the years in question the annual payments did not appear: that was because they were made with capital sums. The mere form of accounts would not be decisive, but the accounts were evidence of a decision upon which action was taken which had positive results and which affected the rights of others. Resolutions as to dividends were passed and were acted upon in reference to accounts which had as their basis that the annual payments were made out of capital and accordingly

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(1) Page 83 *ante*.

(Lord Morris of Borth-y-Gest)

would not diminish the fund available for distribution. The Company elected to pay dividends out of its annual profits as so computed. The facts could not later be altered. If the annual payments had been made out of the annual profits the position of the shareholders would have been altered: they might have been enabled to receive a capital distribution or dividend rather than a dividend with tax deducted. These circumstances serve but to show that the attribution which the Company now seek to make is one which, by entirely inconsistent action, they precluded themselves, on the principles laid down in the *Central London Railway* case([1]), from making.

I would dismiss the appeal.

Lord Upjohn—My Lords, in view of your Lordships' decision in the *Chancery Lane Safe Deposit and Offices Co. Ltd.* v. *Commissioners of Inland Revenue*([2]) this appeal must fail. Even had your Lordships accepted the view of the *Chancery Lane* case which commended itself to my noble and learned friend Lord Reid and to myself, I would have thought that this was a very different case, which could not succeed. I agree that the appeal should be dismissed.

Lord Wilberforce—My Lords, the claim of the Crown based upon s. 170 of the Income Tax Act 1952 is for income tax in respect of certain annual payments, made by B. W. Nobes & Co. Ltd. ("Nobes"), in the years 1957–58, 1958–59 and 1959–60 to Aconite Investments Ltd. ("Aconite"). These payments were made under a deed of covenant dated 12th July 1957 between Nobes and Aconite, at which time Aconite was a wholly owned subsidiary of Nobes. On 18th July 1957 Nobes agreed to sell its shareholding in Aconite to Consolidated Investment Funds Ltd. ("C.I.F."). Under this agreement Nobes became entitled in each relevant year to payments on account of the purchase price which were to equal the net profits of Aconite (as defined in the agreement). In fact C.I.F. in each year made payments approximately equal to the amount of the annual payments to Aconite, which payments were regarded by Nobes as instalments of capital. In the accounts of Nobes for each year the annual sums and the capital payments were entered in a special ledger account headed "Shares in Aconite Investments Limited". The two sides of this account were kept in balance and the transactions did not in these years appear in the Company's profit and loss accounts.

Nobes had some normal trading activities and made profits in each of the years in question, which were taxed under Schedule D, Case I. Out of these profits dividends were paid to Nobes' shareholders from which tax was deducted in accordance with s. 184 (1) of the Act. The taxed profits were large enough to have covered the annual payments to Aconite, but, taking each year by itself, were not sufficient to cover both the annual payments and the dividends paid.

Some other relevant figures will have to be mentioned, but it may be convenient to pause at this point and consider the Company's position as regards tax on the annual payments upon the basis of the facts as I have stated them, the question being whether Nobes has the right to retain the tax deducted from the annual payments or must account for it to the Revenue. The mere fact that the annual payments were, in the Company's books, dealt with in a

([1]) 20 T.C. 102. ([2]) Page 83 *ante*.

A special account and set against the capital sums received from C.I.F., and were not brought into the profit and loss account where the Company's taxed profits appeared, would not of itself prevent the Company from claiming the benefit of s. 169 of the Income Tax Act 1952: there would (to use the accepted expression) be a domestic piece of book-keeping by which the Company would not, as against the Revenue, be bound. But the payment of dividends, expressed to B be after deduction of tax, out of the taxed profits in each year, would, in my opinion, beyond doubt have deprived the Company of the benefit of the section. The authorities have been discussed in *Chancery Lane Safe Deposit and Offices Co. Ltd.* v. *Commissioners of Inland Revenue*[1], and I refer to that discussion: on the facts so far stated, the case would clearly have come within the decision of this House in *Central London Railway Co.* v. *Commissioners of Inland* C *Revenue* 20 T.C. 102, whatever view of that decision is taken. It would have been a clear case.

But it is here that an additional factor comes in, upon which the Appellants rely to escape from these consequences. In a document placed before the Special Commissioners, which is exhibit H to the Case Stated, Nobes set out in tabular form a statement, on the one hand, of all the income tax assessments, D i.e., of the profits or gains brought into charge to tax, since the commencement of the Company's trading in 1951–52 and, on the other hand, of the gross dividends paid by the Company. Taking the years of assessment down to and including 5th April 1957, this showed an aggregate of assessments amounting to £376,609 and an aggregate of dividends paid amounting to £302,421. The difference between these sums—£74,188—represented, it was claimed, a balance E of taxed profits which was available to cover, or "frank", the dividends paid in the three years in question, thus liberating the actual profits of those years to cover the annual payments.

Plowman J. accepted this. There were, he said[2], "accumulated taxed profits of £74,000 odd, out of which the dividends could have been paid." The Court of Appeal did not agree: Harman L.J. thought the past accumulations F of profits were a mere fiction; he described the document which revealed them as unreal and he did not find that there was anything available to cover the post-1957 dividends. I agree with his conclusion. It is certainly open to a company to pay dividends, and to deduct and retain tax on those dividends, if it has taxed profits, from years previous to that in which the payment is made, from which it can do so. By contrast with s. 169, which requires annual payments to be G payable out of taxed profits of the current year, s. 184, the section dealing with dividends, refers to taxed profits generally: and one can see why this is so, for it would be manifestly contrary to sound and existing practice as well as to fiscal justice to limit the right which the section confers to the profits of a single year. But for the right to exist there must not only be *taxed* profits, there must be *real* profits out of which the dividend can be paid.

H Consideration of the scheme of those sections of the Income Tax Act which deal with the distribution of dividends and the deduction of tax therefrom shows, to my mind, that what is being regulated is an actual distribution to shareholders of actual profits of a company which are available for distribution. Section 184(1) states the simplest case: the company's profits are to be taxed in full before "any dividend thereof" is made, the supposition being that a distribution is

(1) Page 83 *ante*. (2) Page 144 *ante*.

(Lord Wilberforce)

made out of precisely those profits which the company has just earned. Section 184 (2) goes on to deal with other cases, giving recognition to the facts (1) that the amount of profits which the company has available for distribution may not correspond with the amount of profits on which it is taxed (for example because the assessment is based on a previous period), (2) that a company may wish to distribute profits which have been earned but not yet taxed. All of this contemplates a distribution of some aggregate of profits which the company has, not of some notional aggregate brought about by accountancy reconstruction—unless of course this reveals the actual existence of distributable profits.

In this case Nobes completely fails to show that any such aggregate of distributable profits existed. Its published accounts (I must take these from the extracts annexed to the Case Stated) show what the position was. In the year 1956–57, in fact on or about 25th March 1957, a gross dividend of £269,565, or £155,000 after deduction of tax, was paid leaving to be carried forward to the credit or profit and loss account for the year 1957–58 only £4,449. Nothing in the Company's accounts suggests that this figure is wrong, nor does the evidence so demonstrate. To show that an extra £74,000 was available much more was needed than a document showing the result of the subtraction of one historical figure from another. Formally to write £74,000 back into the profit and loss account may not have been necessary, but in some way or other the existence of profits to that amount ought to have been shown. Yet there was no information before the Special Commissioners upon which they could have found any such figure, nor did they in fact do so. We were told, indeed, by Counsel for the Appellant Company that the missing £74,000 was to be accounted for—I do not know whether wholly or partially—by payment of taxes which could not be claimed against pre-tax profits. But this does not enable a Court dealing with a Case Stated to find the nature or reality of the figure put forward. The matter was one to be demonstrated to the Special Commissioners—if demonstration was possible at all—and that was not done. In my opinion, therefore, the attempt of the Company to provide, *ex post facto*, cover for the dividends paid does not succeed; the position remains that the dividends were paid out of the taxed profits for 1957–58, 1958–59 and 1959–60 with the result that the annual payments must be treated as paid from another source.

Another more limited argument was one upon which some reliance was placed by the Company, though no reference to it appears in the Case Stated or in the judgments in the Courts below. It was said that at least for the year 1957–58 the relevant figure, for the purpose of considering whence the annual payment was payable, was £115,328—a figure based on the profits of the previous year—and that this figure was sufficient to cover both the annual payment and the dividend. I accept that the figure is sufficient if it can be used, but in my opinion it cannot. The Company had before 31st March 1957 made use of the income tax in respect of the profits of the year ending on that date to cover the tax on the dividend of £155,000 paid on 25th March 1957: this it was entitled to do by virtue of s. 184 (2): and, having done so, it cannot make use of the same sum again to cover the annual payment made in the year 1957–58. The difficulty of the kind of argument which the Appellants present on this point was, I think, present to the mind of Lord Macmillan in *Allchin* v. *Corporation of South Shields* 25 T.C. 445, when he said, at page 465:

> "Payments which could not lawfully be made out of actual profits cannot be deemed to have been made out of corresponding notional profits.

A The profits of the taxpayer as assessed for a particular year, although they may differ widely from his actual profits for that year, are nevertheless compiled from actual figures. If an ingredient of the profits as assessed is derived from a source which precludes the application of that ingredient to the payment of interest on borrowed money or with regard to which the taxpayer has so acted as to preclude himself from being deemed to have
B so applied it, then to that extent I think that the taxpayer is debarred from saying that he has paid the interest in question out of profits or gains brought into charge to tax."

Finally, I should mention one general contention which was put forward by the Appellant Company for the first time in this House. This was based upon some observations made by Viscount Radcliffe in *Commissioners of Inland*
C *Revenue* v. *Frere*(1) [1965] A.C. 402 in which he pointed out that the manner in which the code deals with the tax on annual payments amounts to recognition of a division of proprietary right in the income in question as between the maker and receiver of the payment. It was sought to use this analysis so as to show that in any case where there are taxed, or taxable, profits and an annual payment, the profits are, as it were, *ipso jure* divided in ownership, the con-
D sequence being (in such a case as the present) that the maker of the payment acquires an automatic, or priority, right to the benefit of s. 169 which cannot be affected by any purported distribution of the profits. This is a misuse or at least a misunderstanding of the argument. All that Viscount Radcliffe was saying (as had been said before him, for example, by Lord Davey in *London County Council* v. *Attorney-General*(2) [1901] A.C. 26, at page 42) was that, where you
E find a case to which s. 169 applies, the manner in which the tax is collected or charged against the two persons concerned can be explained, or rationalised, as based upon the conception of a division of property in the income. Nothing in this is of any relevance in the present appeal, where the logically prior problem arises of ascertaining whether the case is one where the annual payment was payable out of profits or gains brought into charge or not. For the reasons given
F I am of opinion that this is not such a case, and consequently that the appeal must be dismissed.

Lord Pearson—My Lords, I agree.

Questions put:

That the Order appealed from be reversed.

The Not Contents have it.

G That the Order appealed from be affirmed and the appeal dismissed with costs.

The Contents have it.

[Solicitors:—Ashurst, Morris, Crisp & Co.; Solicitor of Inland Revenue.]

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(1) 42 T.C. 125, at p. 148. (2) 4 T.C. 265, at p. 299.