No. 323.—COURT OF SESSION (SCOTLAND).—LORD CULLEN.—
14th May, 1910.

COURT OF SESSION (SCOTLAND).—FIRST DIVISION.—
14th and 15th June, 1910, and 16th July, 1910.

HOUSE OF LORDS.—21st and 23rd November, 1911, and
14th December, 1911.

THE SCOTTISH NORTH AMERICAN TRUST, LIMITED, *v.* FARMER
(Surveyor of Taxes).(1)

SCOTTISH NORTH AMERICAN TRUST *v.* FARMER.

Income Tax.—Schedule D.—Interest.—Deduction.—The Appellants are a Company, whose main business it is to buy and sell investments Owing to the value of their purchases of investments abroad exceeding the amount of their available cash, they pledged certain of their securities with their bankers in New York to obtain a fluctuating overdraft, on which interest was charged at current rates from day to day. Subsequently, in addition to the overdraft, the Bank granted the Company a loan with a fixed maximum for six months at 6 *per cent., which was renewed for a further six months, and then terminated. The Bank collected the interest of the pledged securities, and after charging the interest due to themselves, credited or debited the balance to the Company.*

Held, *that the borrowings were not sums employed as capital within the meaning of the* 3rd *Rule of the First Case of Schedule D, and that the interest paid to the bankers in New York was deductible, as an outgoing for the purposes of the business, in computing the liability of the Company for assessment.*

I.—CASE.

At a Meeting of the Commissioners for the General Purposes of the Income Tax Acts and for executing the Acts relating to the Inhabited House Duties for the County of Edinburgh, held at Edinburgh on the 22nd day of December, 1908, the Scottish North American Trust, Ltd. (hereinafter referred to as the Company) appealed against an assessment for the year ending 5th April, 1909, on the sum of £2,404 (duty £120 4*s.*) made upon it under the Income Tax Acts in respect of the profits of the business carried on by it, based upon the average yearly profit during the twenty-seven months from the date of the Company's incorporation to 31st October, 1907. The ground of appeal was that in arriving at the assessable profits deduction had not been allowed of the interest paid by it to bankers in America.

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(1) Reported (First Division of Court of Session) 1910, S.C. 966 and 47 S.L.R. p. 834, and (in H. of L.) 1912 A.C., p. 118.

The assessment was made under 5 & 6 Vict., c. 35, s. 100; Schedule D, First Case; 16 & 17 Vict., c. 34, s. 2, Schedule D; and 8 Ed. 7, c. 16, s. 7; and the sum assessed was arrived at as follows:—

	Year to 31st Oct., 1907. £ s. d.	15 months to 31st Oct., 1906. £ s. d.
Balance of Profit as per P. & L. Account	4,911 7 11	6,119 2 5
Less balance brought forward from previous account	1,119 2 5	
	3,792 5 6	
Add sums debited as expenses and not allowable as deductions:—		
Suspense Account		414 15 4
Income Tax	108 18 11	378 2 2
Interest paid to bankers in America on loans by them to the Company	4,576 13 4	80 5 4
Deduct taxed dividends received by Company	2,179 0 5	7,882 8 5
Profit for year to 31st October, 1907	6,298 17 4	
Loss for 15 months to 31st October, 1906	890 3 2	
Total profit for 2¼ years	5,408 14 2	
Average yearly rate of profit ...	2,404 0 0	

I. The following facts were admitted or proved:—

1. The Company was incorporated on 27th July, 1905, under the Companies Acts as a Company limited by shares. The capital (authorised, subscribed, and paid up) of the Company is £100,000, divided into 100,000 shares of £1 each. The registered office of the Company is in Edinburgh, where the directors and shareholders meet, whence the affairs of the Company are managed, and where all the profits are assessable.

2. The objects of the Company as set forth in the third article of its Memorandum of Association are, *inter alia*, as follows:—

"(1) To carry on investment, financial and banking business "in the United Kingdom of Great Britain and Ireland, "India, the British Colonies and Dependencies, the "United States of America, and in any other foreign "countries or states.

"(2) To purchase, invest in or upon, or otherwise to acquire, "hold, sell, pledge, charge, dispose of and deal in all "or any securities or investments of all classes and "descriptions . .. . . of any company, person, "firm, corporation or trust, carrying on or formed to

" carry on business in the United Kingdom of Great " Britain and Ireland, or India, or any British Colony " or Dependency, or in the United States of America, " or any other foreign country or state, or in the shares, " stocks, bonds, debentures, obligations, scrip or " securities of any British, Colonial or Foreign " Government or authority supreme, municipal, local, " or otherwise."

* * * * *

" (8) To borrow and raise any sum or sums of money by way " of loan, discount, cash credit, overdraft or guarantee, " or upon bills of exchange, promissory notes, bonds " and dispositions in security, cash credit bonds, deben- " tures, debenture stock, mortgages, deposit receipts, " or in any other manner : and to grant security for all " or any of the sums so borrowed, or for which the " Company may be or may become liable, and by way " of such security to dispose, mortgage, pledge or " charge the whole or any part of the property, assets " or revenue of the Company, including uncalled or " unpaid Capital, or to dispose, transfer or convey the " same absolutely, or in trust, and to give to lenders " or creditors powers of sale and other usual and " necessary powers."

" (9) To deal with any bank, bankers or others, in the way " of placing money on current account or deposit, or " to borrow money from such banks, or others, either " with or without the deposit, pledge or assignment " of securities."

* * * * *

" (30) To procure the Company to be registered or recognised " in any British Colony, Dependency or Possession, " or in any foreign country or State."

3. In the course of its business the Company purchased in New York certain bonds, stocks, and other securities of American Railroad and other Companies. The value of the purchases. exceeded the amount of the Company's available cash, and certain of the securities which were lying in New York were pledged to Messrs. Ladenburg, Thalmann & Co., the Company's bankers in New York, in consideration of which the bankers allowed the Company's bank account in New York to be overdrawn. The amount of the overdraft fluctuated from time to time as the Company bought and sold securities, and the Company was charged periodic interest at current rates from day to day. In September, 1906, Messrs. Ladenburg, Thalmann & Co. opened a loan account in addition to the ordinary overdraft with the Company in New York on which they granted a loan not exceeding $200,000 to the Company for a period of six months at 6 per cent. When this loan fell due it was renewed for a further six months, after which the loan account was terminated, and the balance was transferred to current account. Messrs. Ladenburg, Thalmann & Co. collected all the dividends and coupons upon the

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securities in their hands paying the interest due to themselves out of the sums so collected, the difference or net amount being credited to the Company. In the event of the dividends and coupons collected not equalling the amount of the interest payable in any month, the interest was debited to the overdraft on the current account.

II. For the Company it was contended that the item of interest paid to bankers in New York is not liable to tax, and should therefore be deducted before arriving at the net profits assessable for income tax. The interest in question is not annual interest payable out of the Company's profits or gains within the meaning of Rule 4 to Case I., of Schedule D. It is a disbursement or expense incurred by the Company in the Company's business, and allowable by Rule 1 to Cases I. and II. of Schedule D. It is contrary to the whole scope of the Income Tax Acts to treat the interest accruing to an American citizen from advances over property in America as taxable merely because the owner of the property is resident in the United Kingdom. The assessment also is entirely opposed to the principle of taxation at the source. That principle presupposes the right of the person paying the tax in the first instance to recoup himself from some other person. In this case the Company maintains that there is no liability upon it to tax, as the interest is deducted by the lenders from dividends on securities in their own hands, and the Company has no opportunity of deducting the tax on paying the interest. The case of the *Anglo-Continental Guano Works* v. *Bell*, 1894, 70 L.T.R. 670, is not a parallel, as in that case money was advanced by the Company, whose head office was in Hamburg, to their London Branch, and the profits assessed were all earned in the United Kingdom, and on that account were liable to British income tax. The present case is different, the loan being made in America on the security of the property there, and the interest paid to the American bankers is outwith the scope of the Income Tax Acts. The case of the *Alexandria Water Co., Ltd.*, v. *Musgrave*, 1883, L.R. 11, Q.B.D. 174, 49 L.T.R. 287; I.T.C. 521, is not analogous to the present.

III. The Surveyor of Taxes (Mr. Richard Farmer) maintained:—(1) That the interest in question was interest upon capital employed in the business of the Company, and that, therefore, by reason of 5 & 6 Vict. c. 35, s. 100, Case I., Rule 3, it could not be set against or deducted from the profits of the said business; and (2) that the present case is governed by the decisions in the cases of the *Anglo-Continental Guano Works* v. *Bell*, 1894, 70 L.T.R. 670, 3 T.C. 239; and *Alexandria Water Co., Ltd.* v. *Musgrave*, 1883, L.R., 11 Q.B.D., 174, 49 L.T.R., 287; 1 T.C., 521.

IV. The Commissioners, on consideration of the facts and arguments submitted to them, were of opinion that the interest paid to bankers in America was not a legal deduction for income tax purposes, and accordingly they refused the appeal and confirmed the assessment.

The Commissioners were also of the opinion that the sums of money raised by loan and overdraft, as shown in I. were utilised as additional capital.

V. Whereupon the Company declared its dissatisfaction with the determination of the appeal as being erroneous in point of law; and having duly required the Commissioners to state and sign a case for the opinion of the Court of Sessions as the Court of Exchequer in Scotland, this case is stated and signed accordingly.

R. L. ORR.
A. W. T. S. SCOTT.
CHARLES J. G. PATERSON.
} Commissioners.

Edinburgh, 6th May, 1910.

Judgment was given in the Court of Sessions (Scotland), First Division, on the 16th July, 1910.

OPINIONS.

Lord Johnston.—I agree with your Lordships in thinking that the determination of the Commissioners in this case was erroneous. The question is whether, in striking the balance of profits or gains of this Company, the Company is entitled to debit their profit with interest paid to bankers in New York on short loans. It is immaterial that the loans were obtained and used in a foreign country. It is equally immaterial in what form these loans were obtained. They were short, in the sense that they were for short and indefinite periods, borrowed as occasion required, and repaid as opportunity permitted. They were, in fact, banking facilities or advances such as are represented by the ups and downs of a banking overdraft account.

The Company is to be charged duty in respect of its trade (Act of 1842, Schedule D, First Case), and its trade is the dealing in foreign securities. The duty is (First Case, Rule 1) to be computed on a sum not less than the full amount of the profits or gains of such trade without other deduction than is thereinafter allowed. The Inland Revenue say that in estimating the balance of profits and gains and assessing the duty thereon, no sum (First Case, Rule 3) shall be set against or deducted therefrom " for any sum " employed or intended to be employed as capital in such trade," and maintain that the sums in question, borrowed as abovementioned, were so employed as capital. It is fully recognised that the profits or gains of a trade in the sense of the Income Tax Acts are not the profits which reach the partners, or the net profits, but the profits which the business, regarded as an entity, makes by the employment of its capital, and that its capital may be supplied by borrowing as well as be contributed by the partners. But that leaves open the question—When does borrowed money become, for the purposes of the Income Tax Acts, capital of the concern, in respect of which there is to be no deduction in name of interest, and when is it not capital in such sense, so that interest paid for its use is (First and Second Cases, Rule 1) a disbursement or expense, " being money wholly or exclusively " laid out or expended for the purposes of such trade "?

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The dividing line is not easy to draw or to define. But I think that as the term "profits" has, in applying the statutory provisions, been "understood in its natural and proper sense, in a "sense which no commercial man would misunderstand," per Lord Halsbury, L.C., in *Gresham Life Assurance Society* v. *Styles*, L.R. (1892), A.C. 315,(1) so may the term "capital" be understood.

It may be well said that if money is borrowed on a permanent footing, as from year to year, the capital of the concern is in a commercial sense enlarged thereby, and the business extended, whereas no commercial man would consider that his banking facilities were part of his capital, or the consideration he paid for them anything but an expense of his business. And, consistently with this, it is provided (First Case, Rule 4) that "in estimating "the profits and gains arising, as aforesaid, no deduction shall be "made on account of any annual interest or any annuity or other "annual payment payable out of such profits or gains." It is true that this is a negative provision only. It does not say that interest which is not annual may be deducted. But the natural inference is that a distinction is drawn, with intention, between interest which can be properly described as annual, though it may be paid at shorter terms, and interest which cannot be so described, but is casual or anything from day to day upwards, short of annual. I think that the distinction between the two classes of cases may be somewhat aptly described by the use of a term of the Scots Law. Where the interest is payable in respect of an obligation having "a tract of future time," it may, in the sense of the Statute be understood as annual, and where not, not. *See* opinions of Esher, M.R., and Lindley and Bowen, LL.J. in *Goslings & Sharpe* v. *Blake*, L.R., 23 Q.B.D., 324.(2)

And it may be appropriately noticed that the Fourth Rule of the First Case of Schedule D must be read along with Section 102 of the Act, which provides for payment or deduction at the source, as it is said, of income tax on all annuities, yearly interest of money, or other annual payments, and for its deduction by the obligor in making payment to the obligee. That shows that in the conception of the Act, money lent to a business on a tract of future time, is capital invested in it, which should be treated as sharing in profits to the extent of the interest payable upon it, and though, for convenience of collection, the profits are to be treated as a whole, the true owner of this capital should bear his share of tax by deduction on settlement between him and his debtor.

But this provision in Section 102 accentuates the distinction between annual interest of money, and interest which is not annual in the sense of the Act. For if that latter interest is not to be a deduction in ascertaining profits to be brought into charge, but like annual interest is to be taxed in the hands of the debtor, then there is, *firstly*, no provision for the debtor recovering by deduction from his creditor, who ought to bear the burden of the tax just as much as the creditor in annual interest, and, *secondly*, as that interest, not having been indirectly, or at the source, obnoxious to Income Tax ultimately chargeable against the

(1) 3 T.C., 185. (2) 2 T.C., 450.

creditor, must enter into the computation in ascertaining the creditor's profits to be brought into charge, it will, having been taxed once in the hands of the debtor, be taxed, in whole or in part, a second time in the hands of the creditor, contrary to the general scheme of the Act.

Two cases were cited by the Inland Revenue in support of the Commissioners' deliverance, both of them from the English Courts.

The first, the *Alexandria Water Company*, L.R., 11 Q.B.D. 174,(1) does not advance their contention. It only decided that interest on Debentures of a Company is a charge on profits and subject to tax at the source or in the hands of the Company, notwithstanding that the Company's revenue was derived entirely from an adventure in a foreign country, and that the debenture holders were entirely foreigners residing in that foreign country. I see nothing to raise any doubt as to the soundness of this judgment so far as it goes, for there was an important point reserved, but it does not touch the present question.

The other Case is more nearly apposite. It is the *Anglo-Continental Guano Works* v. *Bell*, 1st March, 1894, 70 L.T.R., 670.(2) A foreign firm had a branch house in England, which was conducted on the footing of a separate business. The English house obtained short loans, or accommodation, for the conduct of its business, from the foreign firm and from foreign bankers. I think the case may be relieved of any question regarding the advances by the foreign firm. For I think the Court regarded the foreign firm as really *eadem persona* with the English house. But as regards the advances from bankers, the Case is truly *in pari casu* with the present. Though not binding upon us the authority is one which I must regard with all respect. But after carefully examining it, I am not satisfied with the reasoning of the learned Judges who determined it. The authority of the Case is indeed prejudiced by the following note on the Case in Dowell, 6th Edn., p. 188, which I assume is a correct statement in point of fact: "In practice, however, such interest had always "been allowed as a deduction up to the time of that decision, "*and it has since continued to be so allowed.*" The conclusion which I have myself arrived at is that the deduction in question is not one prohibited by the First Case, Rule 3, as interest on capital employed in the trade in the sense of the Statute, and is one permitted under the First and Second Cases, Rule 1, as "money wholly and exclusively laid out or expended for the "purposes of such trade," and, accordingly, that the Commissioners' deliverance is erroneous.

Lord Salvesen.—The Appellant Company carries on an investment business and, in addition to the power to deal in securities and investments of all classes, it has also power to borrow and raise sums of money by way of loan, discount, cash credit, overdraft, etc., and to grant security for any of the sums borrowed. In the course of its business during the financial year ending 31st October, 1907, the Company took advantage of this last-mentioned power to borrow money in New York for a period of six months,

(1) 1 T.C., 521. (2) 3 T.C., 239.

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and a loan was arranged for a further period of like duration, after which the loan was repaid. The object of the loan was to enable the Company to purchase investments at what it believed to be a favourable time, but when it had no capital of its own available. Formerly money had been borrowed on overdraft, but as better terms could be obtained from the Company's bankers in America for a loan for six months on the footing of the Company depositing the securities purchased with the borrowed money, this method of borrowing was resorted to. In stating the profits for the year in question the Appellant Company deducted the amount of interest paid to the American bankers; but this deduction had been disallowed on the ground that the interest in question was interest on capital employed in the business of the Company and, therefore, could not properly be deducted from the profits of the business. The question for decision is :—Whether the interest was properly deducted in ascertaining the profits.

If the question had arisen for the first time for decision, it would humbly appear to me to present no difficulty whatever. From an ordinary business point of view it seems preposterous to suggest that the money which a trader pays to a bank upon overdraft or on a secured loan forms part of the profits and gains of his business. Money which he receives by way of interest will, no doubt, in the ordinary case go to swell his profits, but how payments which, in fact, diminished his receipts should be regarded as in any sense part of his income, it is at first sight very difficult to understand. The 1st Rule of the First Case under Schedule D does not appear to me to create any difficulty. So far as I can see, the Third Rule has no application to the facts of this Case; and the Fourth Rule which provides that "in estimating "the amount of the profits no deduction shall be made on account "of any annual interest" applies only where the annual interest is payable out of such profits. The interest which a trader pays to a bank with which he deals for financial accommodation is not in any sense payable out of profits. It is an ordinary claim of debt with which the whole assets of the Company or trader are chargeable. There is, besides, the further point which was made by the Appellants that the Fourth Rule is not applicable at all, because the interest which has been deducted here was not annual interest but interest upon short loans, each of which was only for half a year; and according to the decision in the case of *Gosling*, 23 Q.B.D., 324,(1) a customer of a bank who pays interest on such a loan is not entitled in making the payment to deduct income tax from it. It follows that in the Case before us the Appellant Company could not have deducted income tax from the interest which they paid on the short loan already referred to, even if the money had been borrowed from English bankers, and apart from the specialty that the loan was made to them by American bankers who are not liable to be assessed under our income tax laws.

The Fourth Rule was the subject of interpretation by the House of Lords in the *Gresham Life Assurance Society*, 1892, App. Cas. 309.(2) The Society as part of its business granted

(1) 2 T.C., 450. (2) 3 T.C., 185.

annuities in consideration of a lump sum; and in making up its balance sheet deducted from its gross income the sums paid in discharge of its annuity contracts. The obvious propriety of this, from a business point of view, did not prevent the Inland Revenue from maintaining that the interest which the Society paid in discharge of its contractual obligations, formed part of its income for the purpose of assessment under the Income Tax Acts; and that view received the support both of the Queen's Bench Division and of the Court of Appeal. Fortunately for the taxpayers of the country the House of Lords had no difficulty in reaching the opposite conclusion, holding that such annuities were not within the meaning of Rule 4 payable out of profits. Lord Watson said, "Until the payments which they necessitated had been taken into "account it cannot be ascertained whether there are any profits "and gains or not." I think exactly the same thing may be said of the interest paid by the Appellant Company to their bankers.

The same principle lies at the root of the judgment in the case of the *Inland Revenue* v. *Stewart & Lloyds*, 8 F., 1129. The question in that case was whether certain expenditure could be properly deducted before profits were ascertained; and your Lordship in the Chair said that "it all depended on whether this "expenditure was really an outlay to earn profit or was an application of profit earned." Assuming that to be the test it would certainly be a strange abuse of language to say that interest which a trader has had to pay on money borrowed for the purposes of his business is an application of the profits earned, when it may be that the interest exceeds the total amount of the profits.

The only difficulty I have in the Case arises from the decision of the Queen's Bench Division in the *Anglo-Continental Guano Works* v. *Bell*,[1] where it was held that the interest paid by a Company on short loans from its bankers in order to enable it to pay cash for goods ought not to be deducted in arriving at the profits of the Company for income tax purposes. That decision is not binding upon us, for it has never been approved in the House of Lords or, so far as I know, in any subsequent case; and it appears to me to conflict with the opinions of the noble Lords who decided the *Gresham* case.[2] The reasoning by which the judgment was supported is in effect that the profits of a business must be ascertained as such without reference to the consideration whether or not a particular partner or all the partners are trading with borrowed capital; and as supporting this view of the law, reference was made to the *Alexandria Water Company* v. *Musgrave*, 11 Q.B.D. 174,[3] where it was held that no deduction can be made from the profits of a business carried on by a Company for the interest payable on its debenture capital. The decision in the latter case was expressly approved by the House of Lords in the *Gresham* case and may, therefore, be taken to be settled law; although the noble Lords who decided it expressly stated that they did not concur in all the reasons assigned by the Judges of the Court of Appeal for their decision. Lord Herschell held that the interest to the debenture holders was payable out of

(1) 3 T.C., 239. (2) 3 T.C., 185. (3) 1 T.C., 521.

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profits and that there was no more reason why interest on such debenture capital should be deducted from the profits than interest on share capital. As a rule the point is quite immaterial, because Companies in paying their debenture interest deduct the amount of income tax from the recipients who, accordingly, pay the income tax. But the same principle cannot be applied, in my opinion, to interest paid on short loans or overdraft to a banker by a trading firm. As I have already pointed out such trading firms are not entitled to deduct income tax from interest which it pays to its bankers; but the bankers must pay income tax upon such portion of the interest as goes to make up their net profits from their business. It would be just as reasonable to hold that a trader was not entitled to take into account, in arriving at his profits, the rent which he pays for premises in which he carried on his business. Rent is just interest payable for the use of real property, and Lord Watson points out that it was one of the many startling results which the contention of the respondent in the *Gresham* case would involve that such rent would have to be added to the profits instead of being deducted from them. "Profits or gains must be ascertained on ordinary principles of "commercial trading" (per Lord Halsbury) and to the commercial mind it would seem a strange thing that a trader should pay income tax on money borrowed for the purpose of his business and in the ordinary course of it and which if his total profits were less than the interest he paid would have to be paid out of capital and not out of profits at all. Sums paid on the discount of bills or on overdrafts on bank accounts would, on the same principle, not form a deduction from the traders' profits but be added to them for income tax purposes, with the result of creating hopeless confusion in commercial bookkeeping and of enabling the Income Tax Commissioners to levy the tax on, substantially, the same sums from the person who paid and from the person who received the discount or interest. I am of opinion, accordingly, that the decision in the *Anglo-Continental Guano Company's* case ought not to be followed here; and that we must hold that the Commissioners were wrong in the decision at which they arrived.

The Lord President.—I am of the same opinion. I cannot see how temporary accommodation in the course of business ever is or ever can be capital.

Lord Kinnear also concurs in the opinion.

Notice of appeal having been given, the case came before the House of Lords.

Sir R. Isaacs, K.C., A.G., (Sir W. Hunter, K.C., S.G. for Scotland, and J. A. T. Robertson with him) for the Appellants.—The question is whether the Respondents are entitled to deduct interest which was paid on money employed as capital in the business. Although the nominal capital of the Company was £100,000 they held investments at cost amounting to £230,617

and £257,482 for 1906 and 1907 respectively. To effect this it was necessary to borrow capital; the loans from the bankers were therefore loans of additional capital to carry on the business. Rule 3 of the First Case of Schedule D. disallows deduction of "any sums employed or intended to be employed as capital." As the Commissioners have found that the money lent by the bank was utilised as additional capital, the interest cannot be deducted.

The case of *Anglo-Continental Guano Works* v. *Bell* is on all fours with this. It cannot be distinguished by saying that the trading there was in guano and here in money. The borrowing of money is not a feature peculiar to this Company; practically all trading concerns have authority to borrow money for the purposes of the business.

Then there is the case of the *Alexandria Water Company Limited* v. *Musgrave*, disallowing the deduction of interest paid to foreign debenture holders, and the case of *Arizona Copper Company* v. *Smiles* which decided that a bonus of 10 per cent. which was to be paid along with loan interest to the lenders of a loan was also not deductible.

It is true that the question of what is capital is one of degree and that it is often difficult to draw a dividing line between what is capital and what is not; but in this case the money obtained from the bankers is clearly intended to be used as capital and it is immaterial whether the intention was to keep it permanently in the business or to repay it.

Sir W. Hunter, K.C., S.G. for Scotland.—If instead of getting the additional facilities for investment by borrowing upon debentures the Company chose to get continuous overdraft facilities from a bank or to get a loan for a short period and to renew it, that is no reason why in the *Anglo-Continental Guano* case they should get no deduction in respect of the interest payable to the debenture holders while in this case a deduction should be allowed.

The broad principle as to what are profits and gains which Lords Salvesen and Watson sought to apply is not applicable on account of the language of the Statutes and of decided cases.

Atkin, K.C. and Lord Kinross for the Respondents were not called upon.

JUDGMENT.

Lord Atkinson.—My Lords, this is an Appeal from a Judgment of the First Division of the Court of Session, as the Court of Exchequer in Scotland, pronounced upon a case stated under the Taxes Management Act, 1880, by the General Commissioners of Income Tax for the County of Edinburgh at the request of the Respondents. The Respondents were assessed to Income Tax under the Income Tax Acts for the year ending 5th April, 1909, on the sum of £2,404, in respect of the alleged profits of their business carried on by them.

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This sum of £2,404 was claimed by the Appellant to be the average annual profit made by the Respondents from the date of their incorporation on the 27th of July, 1905, during two and a quarter years succeeding. In arriving at the sum of £2,404, no deduction was allowed in respect of two sums of £80 5*s*. 4*d*. paid during the period of trading up to the 31st October, 1906, nor of the sum of £4,576 13*s*. 4*d*. paid during the year ending the 31st October, 1907, as interest to bankers of the Company in America on loans made by them to the Company.

The Respondent Company carries on an investment business. It has under its memorandum of association power to deal in investments and securities of all classes, and has also power to borrow and raise sums of money by way of loan, discount, cash, credit, overdraft, etc., and, further to grant security for any sums of money so borrowed.

Its course of business during the years for which its alleged profits and gains are assessed is set forth in paragraph 4 of the case stated as follows: " 4. In the course of its business the " Company purchased in New York certain bonds, stocks, and " other securities of American Railroad and other companies. " The value of the purchase exceeded the amount of the Com- " pany's available cash, and certain of the securities which were " lying in New York were pledged to Messrs. Ladenburg, " Thalmann & Co., the Company's bankers in New York, in " consideration of which the bankers allowed the Company's " bank account in New York to be overdrawn. The amount " of the overdraft fluctuated from time to time as the Company " bought and sold securities, and the Company was charged " periodic interest at current rates from day to day. In Sep- " tember, 1906, Messrs. Ladenburg, Thalmann and Co., opened " a loan account, in addition to the ordinary overdraft with " the Company in New York on which they granted a loan " not exceeding $200,000 to the Company for a period of six " months, at 6 per cent. When this loan fell due it was " renewed for a further period of six months, after which the " loan account was terminated, and the balance was transferred " to current account. Messrs. Ladenburg, Thalmann and Co. " collected all the dividends and coupons upon the securities " in their hands paying the interest due to themselves out of " the sums so collected, the difference or net amount being " credited to the Company. In the event of the dividends and " coupons collected not equalling the amount of the interest " payable in any month, the interest was debited to the over- " draft on the current account."

It will be observed that the loan was not a loan of $200,000, but a loan up to $200,000. The sum lent in fact might fluctuate from day to day, or week to week, from cipher up to this limit. The interest payable in respect of the sum lent was not annual interest or an annuity or annual payment payable out of profits and gains within the meaning of Rule 4, Section 100, of the Income Tax Act of 1842, no more than was the interest paid on the periodical overdrafts fluctuating in amount. That

is obvious. In *Gosling* v. *Sharp* (Q.B.D. 324),[1] it had already been decided by Lord Justices Esher, Bowen, and Lindley in the Court of Appeal, that interest upon a loan by a banker to a customer for a period of less than a year did not fall within the words "any yearly interest of money or any annuity or "other annual payment" occurring in the 16 and 17 Vict., Cap. 34, Section 40. These words are practically identical with the words of Rule 4. I am therefore at a loss to understand what possible application the decision in the case of *The Alexandria Water Company* v. *Musgrave* (11 Q.B.D. 174)[2] so much relied upon in argument on behalf of the Appellant, has to the present case, inasmuch as the question decided in that case was whether the interest payable every half-year on such a permanent surety as the debentures of the Company fell within the words of Rule 4.

The Appellant, indeed, does not seek to ground on that rule this wholly unprecedented attempt of his to exact taxation. He rests it on Rule 3, a wholly different rule, on the ground (1) that the debit balance against the Company on their current account, as well as the loans made on the loan account, constitute "sums employed or intended to be employed as capital" in the Respondent's trade or business; and (2) that the interest paid by the Respondents to the bank in respect of these loans "comes within the words of the rule as deductions 'for' the "sum so employed as capital."

The case of the *Mersey Docks* v. *Lucas* (8 A.C. 595)[3] decided that the general principle upon which the "profits and gains" of any trade, manufacture, adventure, or concern are to be ascertained for the purposes of the Income Tax Acts is this: that the taxpayer is entitled to deduct from the gross profits of his trade or business the expenses necessary to earn them.

The *Gresham Life Assurance* v. *Styles* (1892) (A.C. 309) [4] establishes that if a taxpayer is trading in money, selling life annuities in consideration of a price received for them, either in a lump sum or by deferred payments, the annuity he sells is precisely in the same position *quoad* this Act as is the coal sold by a coal merchant or the corn sold by a corn merchant, and are no more to be treated *per se* as "profits and gains" of his business than are those material subjects of merchandise to be treated as the "gains and profits" of the business of the merchants who vend them.

The profits and gains of any transaction in the nature of a sale must, in the ordinary sense, consist of the excess of the price which the vendor obtains on sale over what it cost him to procure and sell, or produce and sell, the article vended, and part of that cost may consist of the sum he pays for the hire of a machine, or the services of persons employed to produce, procure, or sell the article.

The second proposition established in the last-mentioned case is that in these Acts, the words "profits and gains" are, where

(1) 2 T.C., 450. (2) 1 T.C., 521. (3) 2 T.C., 25. (4) 3 T.C., 185.

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the context does not otherwise require, to be construed in their ordinary signification. I can see no reason for suggesting that this last-mentioned principle should not apply to the word "capital" when used in these statutes, and that it too, where the context does not otherwise require, should be construed in its ordinary sense and meaning. If then one takes the case of an ordinary joint stock bank, whose business consists in the daily or hourly borrowing of money from the customer who lodges money with it either on deposit or current account, for which the bank becomes the debtor, or of lending money to those whose bills or notes it discounts, or whose securities it takes in pledge, and daily almost hourly, repaying in driblets by the cashing of the lender's cheques, the amount borrowed, then, according to the argument of the Attorney-General, the amount borrowed, fluctuating day by day, if not hour by hour, is to be treated as capital employed in the trade, adventure, or concern of the bank within the meaning of Rule 3, Section 100, of the Income Tax Act of 1842. No reduction, moreover, is to be made in respect of the sums lent by the bank on the discount side of its business. Indeed, the Attorney-General, as I understood, admitted, as he was by the necessities of his argument obliged to admit, that the result would be the same in the case of a joint stock bank, which by its charter or articles of association was absolutely prohibited from increasing its capital, that, it appears to me, simply, amounts to this that the word "capital" must, in this rule, be held to bear a wholly artificial meaning differing altogether from its ordinary signification, though there be no context in the clause requiring that there should be given to it a meaning different from that which it bears in ordinary commercial transactions. In *Bryon* v. *The Metropolitan Saloon Omnibus Company, Limited* (3 D.G. and J., 123) it was held that the borrowing of money for the purposes of the business of the defendants, a carrying company, was a mode of conducting their business within the meaning of the thirty-third and thirty-fourth sections of the Joint Stock Companies' Act of 1858; and the decision has been treated as having also determined that the borrowing by such a company of money by the issue of debentures does not amount to an increasing of the capital of the company. In the *General Auction Estate and Monetary Company* v. *Smith* (1891) (3 Ch. 432), the Plaintiff Company was established for the purchase and sale of estates and property. It granted advances on estates, on property intended for sale, loans on deposits of securities, discounted approved commercial bills and received money on deposit, so that its business resembled to some extent that of the Company in the present case.

Under its memorandum and articles of association it had no express power to borrow money, but it was held that being a trading company it had as such implied power to borrow money for the purposes of its business. At page 441 of the report, Lord Justice Stirling dealt with the former of these authorities thus. He says: "Now upon that it seems to me that the case "of *Bryon* v. *Metropolitan Saloon Omnibus Company* is a

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"direct authority, because what was there done by the Company was to raise money on debenture for the purpose of "more effectually carrying on the business of the Company, "and that this is so is shown, I think, by the remarks of Lord "Justice Lindley on that very case in Lindley on Companies." (5 Edition, 1919; 6 Edition, 290.) He says, after discussing the subject of borrowing by companies: "Connected with the subject of borrowing money is increasing capital. The difference "between them is illustrated by *Bryon* v. *Metropolitan Saloon* "*Omnibus Company*. In that case the capital of a limited joint "stock company had been expended, and a majority of shareholders proposed to borrow money on the credit of the Company. A dissentient minority sought to restrain the majority "from so doing, and reliance was placed on the doctrine that "the capital of the Company could not be increased by borrowing money without the consent of all the shareholders, but "it was held competent for the majority to borrow money on "the credit of the Company, and that the doctrine relied upon "had no application to the case, the capital of the Company "being one thing and that which was sought to be increased "by borrowing (namely the cash in hand) being a different "thing."

These authorities show that money borrowed by such a Company as the Appellant Company in this case in the fluctuating temporary manner in which it has been borrowed by them—the daily borrowing and lending of money being part of their trade and business—is not to be treated under the Joint Stock Companies Act as "capital." There is nothing to show that that word should bear a different meaning in the Income Tax Acts when applied to the proceedings of Joint Stock Companies. The interest is, in truth, money paid for the use or hire of an instrument of their trade as much as is the rent paid for their office or the hire paid for a typewriting machine. It is an outgoing by means of which the Company procures the use of the thing by which it makes a profit, and like any similar outgoing should be deducted from the receipts, to ascertain the taxable profits and gains which the Company earns. Were it otherwise they might be taxed on assumed profits when, in fact, they made a loss.

It only remains to refer to the case of *The Anglo-Continental Guano Works* v. *Bell*(1) so much relied upon in argument in the Court of Session and before your Lordships. On close examination of this supposed authority it will, I think, be found that it does not apply to the present case so directly as seems to have been assumed. In that case a German Company incorporated under the German law carrying on the business of importers and manufacturers of guano, had its head office at Hamburg and branches in London and elsewhere. The London house was carried on as a separate business, with a separate capital, and conducted the whole of the Company's business in the United Kingdom. Sometimes the London House purchased cargoes of guano direct, and in order to pay for them got advances (1) from the head office,

(1) 3 T.C., 239.

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and (2) from bankers abroad, sometimes directly, but usually through the central office. What was decided in the case was that the sum paid for interest on these loans could not be deducted under Rule 3, on the ground that the money borrowed was employed as capital, and that this interest was a sum deducted "for" this capital; but the case was treated as if it were a case between partners engaged in a partnership business, one or all of whom is or are trading with borrowed capital.

At page 244 Mr. Justice Matthew, as he then was, says: "It "appears to me clear when you look at the language of the Act "that what are intended to be assessed are the profits of the parti-"cular business, and that those profits are to be ascertained in the "ordinary way without reference to whether or not a particular "partner or all the partners are trading with borrowed capital." And at page 245 he says: "It is perfectly clear that in the "hands of partners deductions of that class and character are not "to be made because, if made, you would not be ascertaining "what really are the profits, not of the partner, but of the "business." Precisely so, when each of the different members of a firm brings a certain sum of money into partnership, the thing which concerns the Company or firm as a trading entity is the amount brought in, not what it cost each of the contributing members to procure what he brings in. That is a matter as unconnected with the business of the firm as a trading body whose profits as such are to be ascertained, as is the loss a particular partner might sustain on the sale of the securities he might be obliged to dispose of to procure the money he brings into partnership. Mr. Justice Cave deals with the matter in the same way. At page 245 he says: "It seems to me that that is not so—that "the gains of the trade are independent of the question of how the "capital money is found, that the gains of the trade are those "which are made by legitimate trading after paying the necessary "expenses which you have necessarily to incur in order to get the "profits; and that you cannot take into consideration the fact "that the firm or trader has to borrow some portion of the money "which is employed in the business." It does not appear to me that the reasoning on which this decision is based can apply to a bank whose business is the borrowing and lending of money; or to an investment company whose business is conducted as is that of the Respondents in the present case. If it does apply then I can only say I think it unsound as so applied, and am unable to concur in it. Moreover, the decision is not binding on your Lordships' House.

Mr. Atkin, though not called on, pointed out that the words of the Rule are "no sum shall be deducted *for* any sum employed "or intended to be employed as capital," and would have argued, I presume, that these words could not apply to *interest* paid by a trading company for the use of money borrowed for the purposes of their trade. It is not necessary to decide the point. He may be right, but I prefer to rest my Judgment on the broader ground. On the whole, therefore, I am of opinion that the decision appealed against was right and should be affirmed, and the Appeal be dismissed with costs.

Lord Gorell.—My Lords, I have had the opportunity of reading and considering the Judgment of my noble and learned friend which has just been read by him, and I fully concur in it.

Lord Shaw of Dunfermline.—My Lords, I agree.

The Lord Chancellor.—My Lords, I agree.

QUESTIONS PUT.

That the Order appealed from be reversed.

The not-contents have it.

That this Appeal be dismissed with costs.

The contents have it.