No. 23*.—COURT OF SESSION, SCOTLAND (SECOND DIVISION).—11TH, 12TH AND 20TH DECEMBER, 1919.

HOUSE OF LORDS.—21ST AND 22ND FEBRUARY, AND 12TH APRIL, 1921.

JOHN SMITH AND SON *v.* MOORE (H.M. INSPECTOR OF TAXES).(1)

Excess Profits Duty—Profits of trade—Deductions—Purchase price of unexecuted coal contracts—Remuneration of manager of business—Discretion of Commissioners of Inland Revenue—Finality of decision—Finance (No. 2) Act, 1915 (5 & 6 *Geo.* V, *c.* 89), *Section* 40 (1) *and* (2), *and Fourth Schedule, Part* I, *Rules* 1, 3 *and* 5, *and Part* III, *Rule* 1 (*a*)—*Income Tax Act*, 1842 (5 & 6 *Vict., c.* 35), *Section* 100, *Schedule D, First Case, Rule* 3.

Two questions were involved in this case:—(1) *The sole proprietor of a coal merchant's business died on the 7th March*, 1915, *and under the terms of his trust disposition and settlement his son took over the business at a valuation, in which nothing was charged for goodwill. The price paid included a sum of* £30,000, *representing the value of certain unexpired contracts with colliery owners for the supply of coal at fixed prices, all of which contracts expired on or before the 31st December*, 1915. (2) *The son paid one-third of the profits of the business as remuneration to a relative who, it was admitted, was a person concerned in the management of the business. This relative was not employed in the business prior to the war, nor were any expenses incurred in respect of manager's remuneration in the last pre-war trade year. The Commissioners of Inland Revenue refused to allow the deduction of the whole of the remuneration in question and the General Commissioners, on appeal, held that they (the General Commissioners) had no jurisdiction in the matter.*

Held, (1) *by the House of Lords (Viscount Finlay dissenting), that the sum of* £30,000 *paid in respect of the unexpired coal contracts was not an admissible deduction in computing the profits of the business for the purposes of Excess Profits Duty for the accounting period from the 7th March*, 1915, *to the 31st December*, 1915—*by Viscount Haldane and Lord Sumner, on the ground that it was capital expenditure; by Viscount Cave, on the ground that the Excess Profits Duty was a tax on a continuing business, and that for the purposes of the question at issue the change of ownership should be disregarded.*

City of London Contract Corporation *v.* Styles, 2 T.C. 239, *applied;*

(1) Reported Ct. Sess., 1920 S.C. 175, and H.L., [1921] 2 A.C. 13.

and (2) *in the Second Division of the Court of Session, that there was no appeal from the decision of the Commissioners of Inland Revenue on the question of the amount to be allowed as a deduction in respect of manager's remuneration.*

Rex *v.* Commissioners of Inland Revenue (*ex parte* W. France, Fenwick and Co., Ltd.), [1918] 1 K.B. 143; Williamson Film Printing Co. *v.* Commissioners of Inland Revenue, [1918] 2 K.B. 720; *and* Commissioners of Inland Revenue *v.* Auld and Pemberton, [1919] 2 I.R. 66, *followed.*

STATED 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 Division of the City of Glasgow in the County of Lanark, held at Glasgow on the 25th June, 1917, John Smith & Son (hereinafter referred to as the Appellants) appealed against an assessment under Schedule D of the Income Tax Acts, for the year ending 5th April, 1917, on the sum of £27,745, in respect of the profits on an average of the three preceding years of the business of shipping and coal agents carried on by them at 5 Dixon Street, Glasgow, and claimed as a deduction from profits for the year ending 31st December, 1915, which entered into the average, the sum of £30,000 paid during the course of that year to the trustees of the late John Smith, junior, for unexpired coal contracts.

The Appellants also appealed against an assessment for Excess Profits Duty made under Section 38 of the Finance (No. 2) Act, 1915, in the sum of £52,081 for the accounting period from 7th March, 1915, to 31st December, 1915, computed as follows:—

Gross profit on coal account, ...	£98,897	
Sundry discounts and allowances, ...	419	
		£99,316
Expenses, other than management salary to Thomas K. Fair, ...		7,468
		£91,848
Portion of remuneration to Thomas K. Fair, authorised by the Commissioners of Inland Revenue to be allowed, £2,000 per annum for 300 days, ...		1,644
Carried forward		£90,204

Brought forward		£90,204
Add		
Adjustment for decreased capital under Sub-section (2) of Section 41 of the Finance (No. 2) Act, 1915, ...		162
		£90,366
Pre-war standard of profits, ...	£4,137	
Statutory allowance, ...	200	
	£4,337	
Proportion thereof for 300 days, ...		3,564
Excess profits charged to duty, ...		£86,802
Duty thereon at 60 per cent., ...		£52,081

The Appellants claimed that in arriving at the excess profits the following deductions should be made:—

(1) £30,000 paid to the trustees of the late John Smith, junior, for unexpired coal contracts; and

(2) £20,615 17s. 9d. described in the profit and loss account as management salary to Thomas Keith Fair, instead of £1,644 authorised by the Commissioners of Inland Revenue to be allowed.

I. The following facts were proved or admitted, viz.—

(1) The business of John Smith & Son has been carried on for many years, and John Smith, junior, was sole partner up to 7th March, 1915, the date of his death.

(2) By trust disposition and settlement, dated 17th October, 1908, and codicil, dated 7th January, 1909, the said John Smith, junior, left the business after his death to his son John Ross Smith, declaring that "the "whole assets of the said business shall be taken "over at the value which may be ascertained from a "balance sheet made up, as at the date of my death, "by a chartered accountant, but nothing shall be "charged for goodwill," and left the capital of his estate in trust for his children, and their issue. Excerpts from the said trust disposition and settlement, and codicil, are appended hereto, and form part of this Case.(1)

(3) The acting trustees under the aforementioned trust disposition and settlement are:—Mrs. Mary Ross Dron or Smith, wife of testator, Mr. Thomas Keith Fair, son-in-law of testator, and Mr. Alfred William Smith, son of testator.

(1) Omitted from the present print.

(4) John Ross Smith became sole partner of the business from 7th March, 1915, and has since carried it on as a continuing business under the name of John Smith & Son.

(5) A balance sheet was prepared by Aikman & Glen, C.A., dated 27th October, 1915, giving the assets and liabilities of the business as at 6th March, 1915. In this a sum of £30,000 is entered for " coal contracts— " amount to be paid as value of same." On this entry the accountants report as follows :—

" With reference to the value placed upon the coal con- " tracts current at the date of the truster's death, we " have to report that in view of the many contin- " gencies as at that date, viz., 6th March, 1915, " *inter alia*, the duration of the war, Government " export restrictions, freight difficulties, the terms of " the contracts as to deliveries, etc., and in view, " further, that any sale of the contracts to outsiders " might not have been recognised by the colliery " owners, we consider that the value (£30,000) placed " on same, which we understand has been agreed to " by Mr. John R. Smith and the trustees, is in all the " circumstances a fair and equitable one. It appears " to us very doubtful if, in view of all the above con- " tingencies, such a large sum would have been given " at the date of the truster's death by any outside " party taking over the business, and all the risks and " responsibilities under the contracts."

A copy of this balance sheet was produced, is appended hereto, and forms part of this Case.(1) The amount £27,927 18s. 1d. entered in the balance sheet as payable to the trustees by J. R. Smith, was brought out as shown in the statement annexed thereto, which forms part of this Case.(1)

(6) The said coal contracts were entered into by the late John Smith, junior, and several colliery owners, and by the contracts the latter agreed to deliver to the former certain quantities of coal at fixed prices. The said contracts had various terms of duration, but none extended beyond 31st December, 1915.

(7) A profit and loss account for the period from 7th March, 1915, to 31st December, 1915, prepared by Thomas Kelly, C.A., and dated 23rd August, 1916, shows a profit of £71,231 15s. 7d., from which is deducted £30,000 as " sum paid to the trustees of the late John " Smith, being agreed on value of current contracts " taken over by the new firm." A copy of this profit and loss account was produced, is appended hereto, and forms part of this Case.(1)

(1) Omitted from the present print.

(8) The Appellants admitted that the said Thomas Keith Fair was son-in-law of the late John Smith, junior, and brother-in-law of John Ross Smith; that he signed cheques on behalf of the Appellants; that, together with John Ross Smith, he managed the business of the Appellants, and was a manager or a person concerned in the management of the business; that the said sum of £20,615 17s. 9d. paid to him was not calculated by reference to the profits of any section of the business, but consisted of one-third of the profits of the firm; that he was not an employee of the business before the outbreak of the present war; and that in the last pre-war trade year no sums were allowed or paid for remuneration of managers.

II. Mr. J. Condie S. Sandeman, K.C., Advocate, attended on behalf of the Appellants and withdrew the claim to have the £30,000 paid for unexpired coal contracts deducted *for Income Tax purposes* from the profits of the year ending 31st December, 1915.

In support of the Excess Profits Duty appeal he contended :—

(1) That the contracts to secure certain quantities of coal at fixed prices made by John Smith, junior, with several colliery owners were, in so far as not completed at the date of his death, taken over by his son John Ross Smith on succeeding to the business, who paid £30,000 for them to John Smith, junior's trustees, after arranging verbally with the colliery owners that the contracts would remain in force.

(2) That the Appellants are entitled to deduct the £30,000 in arriving at their profits, as their profit is clearly the difference between the sum realised from the sale of coal, and what they paid for it, less business expenses.

(3) That they were not investing capital in the sense in which it was done in the case of the *City of London Contract Corporation, Limited* v. *Styles*[1], (1887) 4 T.L.R. 51.

(4) That the trustees of the late John Smith, junior, paid Estate Duty on the £30,000 as part of the estate of the deceased and the Crown cannot now include that sum as a part of the profits of the Appellants for Excess Profits Duty.

(5) That the Appellants are entitled to pay to Thomas Keith Fair any sum they consider necessary and proper for his services, and the question of increase cannot arise within the meaning of Section 49 (2) of Finance Act, 1916, as Mr. Thomas Keith Fair was not an employee of the Appellants prior to the outbreak of the present war.

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[1] 2 T.C. 239.

(6) That the success of the business was largely due to the part taken in the management by Mr. Thomas Keith Fair, who was entitled to the sum of £20,615 17s. 9d. paid to him, and consequently the Appellants are justified in deducting that amount from their profits.

III. Mr. M. C. Furtado, Superintending Inspector of Taxes, on behalf of the Crown, contended :—

(1) That under Sections 38 and 45 of Finance (No. 2) Act, 1915, the Appellants, as persons owning or carrying on the trade or business for the time being, were liable to Excess Profits Duty on the excess profits arising from the trade or business within the accounting period.

(2) That the sum of £30,000 having been admitted not to be a good deduction for Income Tax purposes, it is equally not a good deduction for Excess Profits Duty purposes.

(3) That the profits of the year ending 31st December, 1915, were divided into two parts in accordance with audited accounts furnished, and the trustees of John Smith, junior, have paid the Excess Profits Duty amounting to £9,537 14s., in respect of the profits arising in the period to 7th March, 1915, the date of John Smith, junior's death. The balance arose in the period subsequent to that date and was assessed upon the Appellants and now fell to be paid by them.

(4) That Appellants' profits for the accounting period under review, according to the profit and loss account produced, amounted to £71,231 15s. 7d., and that the destination of the profits was immaterial.

(5) That the sum of £71,231 15s. 7d. was admitted to be the profits of the period in question in computing the profits of the year 1915 for Income Tax purposes in assessing the Appellants who carried on a continuing business.

(6) That under Section 40 of the Finance (No. 2) Act, 1915, the profits arising from the business were to be determined for the purpose of Excess Profits Duty on the same principles as for Income Tax, subject to the modifications contained in the First Part of the Fourth Schedule to that Act; and that none of these modifications authorised the deduction of the £30,000.

(7) That the price paid for contracts was not an admissible deduction from profits, in support of which he referred to the case of *The City of London Contract Corporation, Limited* v. *Styles*[1], (1887) 4 T.L.R. 51.

(8) That the fact that profits of a business, as they arise, must bear taxation in the hands of the person carrying on the business was a factor in determining the

[1] 2 T.C. 239.

price which that person would pay to acquire a right which would produce profit. That no bargain made by the Appellants and their predecessor or his trustees could affect the taxation on the profits of the business as they arose.

(9) That the claim to deduct the £30,000 could not have been made if John Smith, junior, had not died, and the argument is untenable that, because of his death, the profits arising from the business were less by £30,000 than they would have been if he had lived, and the same business had been transacted.

(10) That the fact that the £30,000 was subsequently returned by the trustees for Estate Duty purposes, and that Estate Duty was paid on it had no bearing on the liability to Excess Profits Duty.

(11) That, as Mr. Thomas Keith Fair was a person concerned in the management of the business, and as no remuneration of managers was paid or allowed in the last pre-war trade year, the General Commissioners were precluded by Rule 5 of Part I of the Fourth Schedule to the Finance (No. 2) Act, 1915, from allowing the deduction of more than £1,644 of his remuneration of £20,615 17s. 9d., in the absence of any empowering direction by the Commissioners of Inland Revenue.

(12) That Section 49 (2) of the Finance Act, 1916, does not empower the Commissioners to allow the amount of £20,615 17s. 9d., but merely provides machinery as between employer and employee in the event of the Commissioners of Inland Revenue having refused to allow a deduction.

IV. After considering the whole of the facts and arguments, the Commissioners held for the purposes of the Excess Profits Duty :—

(1) That the sum of £30,000 paid to the trustees of the late John Smith, junior, for unexpired coal contracts was not an admissible deduction from the profits of John Smith & Son during the accounting period from 7th March, 1915, to 31st December, 1915; and

(2) That, as it had been admitted in evidence that Mr. Thomas Keith Fair is a manager or person concerned in the management of the business, the question of the amount to be deducted in respect of his remuneration is one entirely for the determination of the Commissioners of Inland Revenue in London, and consequently, the Commissioners for General Purposes of the Income Tax Acts in Glasgow have no jurisdiction in the matter.

The Commissioners accordingly refused the appeal.

V. Whereupon, Mr. Sandeman, on behalf of the Appellants, declared his dissatisfaction with the Commissioners' 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 Session as the Court of Exchequer in Scotland, this Case is stated and signed accordingly.

WILLIAM CLARK,
JOHN URE PRIMROSE,
CHAS. J. CLELAND,
} Commissioners.

C. H. MILLYARD,
Clerk to Commissioners.

Glasgow, 29th day of August, 1919.

The case came before the Second Division of the Court of Session (the Lord Justice Clerk, and Lords Dundas, Salvesen and Guthrie) on the 11th and 12th December, 1919, when judgment was reserved.

Mr. Constable, K.C., and Mr. D. P. Fleming appeared as Counsel for the Appellants, and the Solicitor-General (Mr. T. B. Morrison, K.C.) and Mr. R. C. Henderson for the Crown.

Judgment was delivered on the 20th December, 1919, in favour of the Crown on both points (Lord Salvesen dissenting on the question of the unexecuted coal contracts), with expenses.

I. INTERLOCUTOR.

Edinburgh, 20th December, 1919. The Lords having considered the Stated Case and heard Counsel for the parties, Dismiss the Appeal, Affirm the determination of the Commissioners and Decern: Find the Appellants liable to the Respondent in expenses and remit the Account thereof to the Auditor to tax and to report.

(*Sgd.*) CHARLES SCOTT DICKSON, I.P.D.

II. OPINIONS.

The Lord Justice Clerk (Scott Dickson).—This case raises questions as to whether two sums of £30,000 and £20,615 17s. 9d. are liable to be included in the Appellants' profits for purposes of Excess Profits Duty.

The facts giving rise to the questions are that the deceased, John Smith, junior, carried on the business of a coal merchant under the name of John Smith & Son. On his death, he instructed his Trustees under his Trust Disposition and Settlement to make over his business with its whole assets to his son, the Appellant, at a valuation (nothing falling to be charged for goodwill) all as prescribed by the said Trust Disposition and Settlement. One of the items in the valuation was £30,000,

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being the amount to be paid as value of coal contracts. The facts as to these contracts are thus stated in the Case. The Accountants reported as to said item in the terms set out on page 5 of the Print as follows: "With reference to the "value placed upon the coal contracts current at the date of "the truster's death, we have to report that in view of the "many contingencies as at that date, *viz.*, 6th March, 1915, "*inter alia*, the duration of the war, Government export re-"strictions, freight difficulties, the terms of the contracts as to "deliveries, etc., and in view, further, that any sale of the "contracts to outsiders might not have been recognised by "the colliery owners, we consider that the value (£30,000) "placed on same, which we understand has been agreed to by "Mr. John R. Smith and the trustees is in all the circumstances "a fair and equitable one. It appears to us very doubtful if, "in view of all the above contingencies, such a large sum "would have been given at the date of the truster's death by "any outside party taking over the business and all the risks and "responsibilities under the contracts."

In Article 7 the £30,000 is stated to have been shown in the Profit and Loss Account as "Sums paid to the trustees of the "late John Smith, being agreed on value of current contracts "taken over by the new firm."

The Commissioners held that this £30,000 was not an admissible deduction from the profits during the accounting period from 7th March, 1915, the date of John Smith, junior's death, to 31st December, 1915—hence this appeal.

The charging section for Excess Profits Duty is Section 38 of the Finance (No. 2) Act, 1915. By Section 40 (1) of that Act the profits for said duty are to be determined on the same principles as profits are determined for the purpose of Income Tax, subject to certain modifications and particularly to those set out in the First and Third Parts of the Fourth Schedule to the said 1915 Act.

By Section 40 (2) provisions are made for the ascertainment of the capital in terms of the Third Part of said Schedule, and the percentages to be allowed on the capital.

By the said Schedule, Part I, Rule 1, the profits are to be taken as the actual profits arising in the accounting period and by Rule 3 deductions for any expenditure of a capital nature in respect of the trade or business shall not be allowed except such as may be allowed under the Income Tax Acts.

By Rule 1 of Part III of said Schedule "The amount of the "capital of a trade or business shall so far as it does not consist "of money, be taken to be (*a*) so far as it consists of assets "acquired by purchase, the price at which those assets were "acquired, subject to any proper deductions for wear and tear "or replacement."

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The Appellants' case was that the whole £30,000 should be deducted, while the Respondent contended that no deduction should be allowed from or in respect of said £30,000. No case was presented for either party for any restriction or modification of said £30,000.

In the balance sheet made up at the truster's death, the £30,000 is entered against " Coal contracts—amount to be paid as value of same." In my opinion, the said £30,000 paid for and as the value of the said coal contracts formed part of the capital of the new concern during the accounting period under the said statute of 1915. The £30,000 is entered, and I think rightly entered, in the balance sheet dated 27th October, 1915, as part of the capital of the business as at 6th March, 1915, when John Smith, junior, died, under the item " Value of coal contracts," see page 14 of Print. That sum of £30,000 was also entered in the Profit and Loss Account for the accounting period as having been paid out of the profits for that period—see page 17 of Print.

I am of opinion that, on a proper construction of the said Act of 1915, the said sum of £30,000 was a payment out of profits for the purchase of part of the capital of the new concern, and that, though the new concern thought proper to apply part of their profits for the purpose of paying for that part of their capital assets represented by coal contracts, that does not cause the part of the profits so applied to cease to be profits or free it from the charge of Excess Profits Duty.

This £30,000 when it was agreed to be paid was not to be paid as the price of coal belonging to the firm of which John Smith, junior, was the sole partner. John Smith, junior, was not possessed of or the owner of any such coal. But he was in right of contracts under which he was entitled to receive coal from certain coal owners at what has become in consequence of the state of the coal trade favourable prices for the buyer. These contracts gave John Smith, junior, certain valuable rights (what are called in English law " choses in action ") which he was entitled to sell and which formed part of the assets of the business belonging to him. Such contractual rights or choses in action as we are here dealing with may be made subject of assignment and sale—Bell's Principles, 10th Edition, Section 1459, *Tolhurst* v. *Associated Portland Cement Manufacturers*, [1903] A.C. 414, and *Scottish Australian Mining Co.* v. *The New Redhead Estate and Coal Co., Ltd.*, decided in the Privy Council, (1919) 89 L.J.P.C. 41. But no question is raised as to the transferability of the rights under said contracts in this case. But such rights are not goods in any sense—they are expressly excluded from the definition of goods under the Sale of Goods Act, 1893, and I cannot regard the price paid for them as being the price of coal which the Appellants' business subsequently acquired, though the Appellants having bought these rights were

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subsequently entitled by virtue of that purchase to buy coal from somebody else on more favourable terms than, but for the purchase of these contractual rights, they otherwise could have done.

The Appellants found very strongly on *Farmer* v. *The Scottish North American Trust*(1), 1912 S.C. (H.L.) 26, and particularly on Lord Atkinson's judgment at the foot of p. 29, and on *J. and M. Craig (Kilmarnock), Ltd. v. Inland Revenue*, 1914 S.C. 338. Of course, these judgments are binding on us, and I accept and respectfully agree with them. But they do not appear to me to affect the present case. They were both before the passing of the Act of 1915 and were therefore in no way affected by the statutory definition of capital contained in the Schedule to that Act.

This is the result at which I would have arrived apart from authority and on the construction of the 1915 Act, but I am further of opinion that this point has been dealt with by judicial authority which, though it may not be binding upon us, seems to be thoroughly sound, and, though pronounced on a construction of Income Tax legislation, to be equally applicable to Excess Profits Duty; I refer to the cases of *City of London Contract Corporation* v. *Styles*, (1887) 2 T.C. 239, and *Alianza Company* v. *Bell*, [1905] 1 K.B. 184, 5 T.C. 60 and 172. I think the Appellant entirely failed to show that the reasoning in these cases did not apply to the present case, or to assail successfully that reasoning.

I am therefore of opinion that the appeal as to the £30,000 fails.

The facts as to the other branch of appeal are as follows: the £20,615 17s. 9d. is management salary paid to T. K. Fair, and sought to be deducted from the profits made during the accounting period. The Commissioners of Inland Revenue have under this head allowed a deduction of £1,644 being at the rate of £2,000 a year. Statement (8) in Article I of the Case sets out the facts as follows: "The Appellants admitted that the said "Thomas Keith Fair was son-in-law of the late John Smith, "junior, and brother-in-law of John Ross Smith, that he signed "cheques on behalf of the Appellants; that, together with "John Ross Smith, he managed the business of the Appellants, "and was a manager or a person concerned in the management "of the business; that the said sum of £20,615 17s. 9d. paid "to him was not calculated by reference to the profits of any "section of the business, but consisted of one-third of the profits "of the firm; that he was not an employee of the business "before the outbreak of the present war; and that in the last "pre-war trade year no sums were allowed or paid for "remuneration of managers."

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(1) 5 T.C. 693, at p. 705.

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The decision of the Commissioners was as follows: "That, "as it had been admitted in evidence that Mr. Thomas Keith "Fair is a manager or person concerned in the management of "the business, the question of the amount to be deducted in "respect of his remuneration is one entirely for the determination "of the Commissioners of Inland Revenue in London, and, "consequently, the Commissioners for General Purposes of the "Income Tax Acts in Glasgow have no jurisdiction in the "matter."

This part of the appeal depends on the construction of Rule 5 of Part I of said Fourth Schedule. In my opinion that Rule entirely supports the view given effect to in the finding of the Commissioners appealed against, and the appeal on this head also fails.

It appears to me the point is ruled by the cases of *Rex* v. *Inland Revenue Commissioners* (ex parte *W. France Fenwick and Co., Ltd.*), [1918] 1 K.B. 143, *Williamson* v. *Inland Revenue Commissioners*, [1918] 2 K.B. 720, and *Inland Revenue Commissioners* v. *Auld*, [1919] 2 I.R. 66.

Lord Dundas.—I concur.

Lord Salvesen.—I have the misfortune to differ from the rest of your Lordships so that my opinion has no influence on the decision, but as I have formed a clear opinion that the Commissioners reached an erroneous result it is my duty to explain my reasons.

In *Farmer* v. *Scottish North American Trust, Limited*(1), 1912 S.C. (H.L.) 26, Lord Atkinson said, in the course of delivering judgment, "the profits and gains of any transaction "in the nature of a sale must in the ordinary case consist of the "excess of the price which the vendor obtains on sale over what "it cost him to procure and sell the article vended." This simple proposition appears to me to be sufficient for the disposal of the case. The Appellants bought at a valuation certain coal contracts into which their predecessors had entered for delivery of certain quantities of coal during the year of assessment. Had there been no rise in the market price of coal since the contracts were made, or in other words if the Appellants had been able to contract for coal at the same rates as those in the current contracts which they took over, these current contracts would have no value as subjects of sale. As in this case, however, £30,000 was the value put on the right to obtain delivery at the date of the late John Smith junior's death it may be assumed that coal had at 7th March already risen largely in price and a further large rise enabled the Appellants not merely to pay the £30,000 and the contract prices of the various lots of coal purchased but to make very large additional profits. On these they do not dispute

(1) 5 T.C. 693, at p. 705.

(Lord Salvesen.)

their liability to the assessed for Excess Profits Duty. But that they should also have to pay Excess Profits Duty on part of the purchase price of the coal by the sale of which they made their profits is a proposition to which I cannot give my assent. If they had not paid the £30,000 they could not have got delivery of the coals by the sale of which their profits were made. On the same principle the price they paid to the collieries ought also to be deducted although this is not suggested. But the £30,000 is just part of the price to them of the goods in the sale of which their business consisted. They bought the coals not from the colliery direct but from a middleman who demanded a profit before he would part with his rights. An article may be sold several times over at increasing prices and each vendor may make a profit by the transaction, but the excess of the price that the last speculator obtains for the article over and above what he paid is the profit which he makes—not the difference between the price at which the article was first bought from the producer and the price at which after having changed hands several times it was ultimately sold to the customer. In my opinion the case would be exactly the same if the coals had all been delivered and lay in the vendor's yard but he had refused to sell them unless he got £30,000 more than he had himself paid for the coals. A right to obtain coals under a contract with a colliery is for commercial purposes equivalent to possession of the actual coals and in the coal export trade it is common knowledge that this is the ordinary way in which coals are dealt in. The coals are not binged but are sent direct to the ships by which they are to be exported, the sale being effected by the purchaser from the colliery.

Had there been no further rise in price but the Appellants had simply realised by sale the price paid by them (including the £30,000) plus the amount of the pre-war profits the result would have been that in Your Lordships' view they must be assessed as for excess profits on this sum or in other words would have to pay £18,000 out of capital in name of Excess Profits Duty although they had not earned a penny of profit. I can find no warrant for so construing the statute. Its object was not to confiscate capital used in trading, but to levy a tax on profits made by trading. Where no profits are made the Act has no application. I am therefore of opinion that the Appellants are entitled to the deduction of £30,000 which they claim before being assessed on the balance for Excess Profits Duty. On the other point raised I agree with the finding of the Commissioners.

Lord Guthrie.—The Commissioners have decided that the sum of £30,000, paid for unexpired coal contracts, by the Appellants to the trustees of the late John Smith, junior, (at his death the sole partner in the firm) in connection with the acquisition by the Appellants, under the provisions of John Smith's will, of the business previously carried on by him cannot, either for

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Income Tax purposes, or in a question of Excess Profits Duty, be deducted from the profits of the business. The Appellants have withdrawn their claim for deduction for Income Tax purposes, and I take the case as if no such claim for deduction had been made; and on the footing that they make no admission of liability and that their actions do not imply any admission of liability for Income Tax purposes.

The question depends on whether this sum of £30,000 is to be treated as capital or as income. It was argued that the sum in question was not capital, because it was paid by the firm for rights which expired within a year from the death of the late John Smith, junior, and the acquisition of the business under his father's will by John Ross Smith, his son, the present sole partner. As I understood the argument it was scarcely disputed that if the deliveries under the contracts had extended over a period of years, the sum paid therefore must have been treated as part of the capital of the business. It was argued that the case of the *City of London Contract Corporation, Limited* v. *Styles*, (1887) 2 T.C. 239, did not apply because, for aught that appeared in that case, the unexpired contracts there in question might have extended over a series of years.

I am unable to distinguish the present case from that of *Styles* and I think that the decision in that case was right. It seems to me that the expenditure of this sum of £30,000 was made as part of the arrangements for acquiring the business. The money was spent for the right to stand in the position of the old firm under certain coal contracts. In the words of Lord Justice Bowen in the case of *Styles* it was capital used to acquire the concern. It was said that the sum in question was in the same position as if the coal deliveries to which the firm became entitled had been in bing in the firm's yard at the death of John Smith, junior. I cannot assent to this view. I do not agree that the price paid by the new firm to the trustees of John Smith, junior, for such a bing could have been deducted from annual profits in a question of Excess Profits Duty. But suppose it could, the property in a bing of coal and the right to get deliveries of coal of unknown amount at unknown prices seem to me essentially different things. Had the subject in question been a bing of coal I suppose on the Appellants' argument the amount saleable within a year after the beginning of the new firm would fall to be deducted and the amount not realizable till a later period could not be so treated.

But I agree with your Lordship in the chair and Lord Dundas that whether the case of *Styles* is well decided or not and whether it was applicable or not, the matter is settled by the express terms of the Fourth Schedule to the Finance (No. 2) Act, 1915, Part III, Rule 1. The rights bought by the new firm from the late Mr. Smith's trustees seem to me assets of the business

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acquired by purchase and the sum of £30,000 is the price at which these assets were acquired. If so, this sum is part of the capital of the trade or business. It cannot fall under the exception in the opening words of the Rule for it is not money in the hands of the firm, and if the word " money " can be construed in a taxing statute to include money's worth, which I do not think it can, it is not in my opinion money's worth.

On the second question I agree with your Lordship.

The Company having appealed against this decision as regards the question of the unexecuted coal contracts, the case came before the House of Lords (Viscount Haldane, Viscount Finlay, Viscount Cave and Lord Sumner) on the 21st and 22nd February, 1921, when judgment was reserved.

Sir John Simon, K.C., Mr. A. M. Latter, and Mr. D. P. Fleming (of the Scottish Bar) appeared for the Appellants, and the Attorney-General (Sir Gordon Hewart, K.C.), the Lord Advocate (Mr. T. B. Morrison, K.C.), Mr. R. C. Henderson (of the Scottish Bar), and Mr. R. P. Hills for the Crown.

Judgment was given on the 12th April, 1921, in favour of the Crown with costs (Viscount Finlay dissenting), confirming the decision of the Court below.

JUDGMENT.

Viscount Haldane.—My Lords, the question in this appeal is whether the Appellants are entitled to deduction of a certain sum of £30,000 in the estimation of the excess profits on which they were liable under Section 38 of the Finance (No. 2) Act, 1915, for Excess Profits Duty, in an accounting period between 7th March, 1915, and 31st December in the same year. The Appellants say that this £30,000 was a disbursement or expense incurred by them for the purposes of their trade or business, and necessitated in order to earn its profits, having in truth been paid for the purchase of coal as part of their stock-in-trade. The Respondent, the Surveyor of Taxes in Glasgow, who contests this claim on behalf of the Crown, says that the £30,000 was capital expenditure which cannot, consistently with the Statute, be deducted. He contends that it was paid, not as the price of coal for stock-in-trade, but as part of the price given for a business which the Appellants acquired, the value of which formed part of the capital of their own business. The Second Division of the Court of Session, sitting as the Court of Exchequer in Scotland in the exercise of original jurisdiction, and consisting of the Lord Justice Clerk, Lord Dundas, Lord Salvesen and Lord Guthrie, decided by a majority in favour of

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the Respondent, Lord Salvesen dissenting. The question was brought before them on a Case stated under the Taxes Management Act of 1880. There was another point on which the judgment of the Court of Session was taken, as to an allowance for management salary of £20,615 17s. 9d. to a Mr. Fair as a manager of the business. This latter point was, however, abandoned at the Bar of the House, and has not to be considered.

In the accounting period between the 7th March and the 31st December, 1915, the gross profits made by the firm on certain coal contracts amounted to £98,897, and, after deducting expenses and making adjustments, there remained £90,366, which was taken as the profit in the period through which the Appellants were assessed for Excess Profits Duty. It is from this amount that the Appellants claim to be entitled to make the deduction in controversy. My Lords, it is necessary in the first place to state the circumstances under which the Appellants became entitled to the business. The late John Smith, junior, died on 7th March, 1915. At the time of his death he was carrying on alone the business of John Smith & Son, a firm which had pursued the business of coal and shipping agents for many years. By a trust disposition and settlement he directed his trustees to make over the business after his death, in the events which happened, to his son John Ross Smith. The goodwill and firm name were to belong to the latter without payment for them. But he declared that " the whole assets of the said " business shall be taken over at the value which may be ascer- " tained from a balance sheet made up as at the date of my " death by a chartered accountant, and nothing shall be charged " for goodwill."

My Lords, pausing here I will state the interpretation which, as I think, ought to be placed on the trust disposition. It appears to me that the testator meant to leave his business as an entirety to his son, the Appellant, subject only to this qualification that his son should be willing to pay over to the trustees an amount in respect of what was so given to him which would in part fill the gap in the testator's estate made by his gift. Nothing was to be payable in respect of the goodwill, but the amount to be replaced was to be ascertained by a valuation of all the other assets as they stood in the business at the date of the testator's death. These assets were to pass under the gift along with the business and its goodwill, if the son elected to take them, and he was to be charged not as on a sale to him of each asset in the open market but on a valuation, to be made in the manner prescribed, of the whole assets of the business, the goodwill being included without charge for it. My Lords, the Appellant elected to take on the terms of the will, a firm of chartered accountants prepared a balance sheet in which they valued the assets, among which were two especially valuable items, debts outstanding as due to the firm, amounting, with

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agents' balances, to over £32,000, and coal contracts which the accountants valued at £30,000. These contracts had been entered into by the testator with several colliery owners, and under them the latter had agreed to deliver over periods certain quantities of coal at prices which turned out in the end to have been very advantageous. The accountants stated, in a note to their balance sheet, that having regard to contingencies existing at the date of the testator's death, and to a doubt whether sales to outsiders of the contracts would have been recognised by the colliery owners, they thought the amount of £30,000 in all the circumstances a fair and equitable one. The Appellant took over the business as from the 7th March and carried it on through the accounting period to 31st December, 1915. He made the profit, by means of these coal contracts, of £90,000, to which I have already referred. The contracts were contracts which apparently were for short terms and it was therefore necessary to realise their fruits. This was done and a large profit was the result.

My Lords, profit may be produced in two ways. It may result from purchases on income account, the cost of which is debited to that account, and the prices realised therefrom are credited, or it may result from realisation at a profit of assets forming part of the concern. In such a case a prudent man of business will no doubt debit to profit and loss the value of capital assets realised, and take credit only for the balance. But what was the nature of what the Appellant here had to deal with? He had bought as part of the capital of the business his father's contracts. These enabled him to purchase coal from the colliery owners at what we were told was a very advantageous price, about fourteen shillings per ton. He was able to buy at this price because the right to do so was part of the assets of the business. Was it circulating capital? My Lords, it is not necessary to draw an exact line of demarcation between fixed and circulating capital. Since Adam Smith drew the distinction in the Second Book of his "Wealth of Nations," which appears in the chapter on the Division of Stock, a distinction which has since become classical, economists have never been able to define much more precisely what the line of demarcation is. Adam Smith described fixed capital as what the owner turns to profit by keeping it in his own possession, circulating capital as what he makes profit of by parting with it and letting it change masters. The latter capital circulates in this sense. My Lords, in the case before us the Appellant, of course, made profit with circulating capital, by buying coal under the contracts he had acquired from his father's estate at the stipulated price of fourteen shillings and reselling it for more, but he was able to do this simply because he had acquired, among other assets of his business, including the goodwill, the contracts in question. It was not by selling these contracts, of limited duration though they were, it was not by parting with them to other masters,

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but by retaining them, that he was able to employ his circulating capital in buying under them. I am accordingly of opinion that, although they may have been of short duration, they were none the less part of his fixed capital. That he had paid a price for them makes no difference. Indeed the description of their value by the accountants, in the words I have earlier referred to, as of doubtful validity in the hands of outsiders, emphasises this conclusion. The £30,000 paid for the contracts, therefore, become part of the Appellant's fixed capital and could not properly appear in his revenue account. If that be so, then it was a sum employed as capital in his trade, and has to be excluded as a deduction from the profits on which he is assessed. This results from the express provisions of Sections 38 and 40 of the Finance (No. 2) Act, 1915, which governs his case, and the first part of the Fourth Schedule to that Act, which incorporates certain analogous provisions of Schedule D of the Income Tax Act of 1842, including Rule 3 of the First Case. Capital, within the meaning of these provisions, seems to me in any view to include such fixed capital as I think we have described to us in this appeal.

For these reasons I have come to the conclusion that the contention for the Crown is right, and that the appeal ought to be dismissed with costs.

Viscount Finlay.—My Lords, in this case the Appellant, John Ross Smith, who carries on business under the name of "John Smith and Son", appealed to the Court of Session against an assessment for Excess Profits Duty made under Section 38 of the Finance (No. 2) Act, 1915, in the sum of £52,081 for the accounting period from the 7th March, 1915, to 31st December, 1915. He claimed that in arriving at these profits deduction should be made for £30,000 paid to the trustees of his father, the late John Smith, junior, for unexpired coal contracts. The business is that of a coal exporter, and it has been carried on for many years. John Smith, junior, was the sole partner up to his death on the 7th March, 1915. By his trust disposition and settlement, dated 7th January, 1909, he appointed trustees to whom he made over his whole estate in trust. The third trust was to make over to the Appellant, who is himself one of the trustees, the said business of coal exporter, the goodwill to belong to the Appellant without any payment being made by him for it, declaring that the whole assets of the said business shall be taken over at the value which may be ascertained from a balance sheet made up as at the date of the testator's death by a chartered accountant. The capital of the estate was left on trusts. The Appellant became the sole partner in the business as from 7th March, 1915. A balance sheet was prepared as directed by the settlement. It showed £27,927 18s. 1d. to the credit of the trustees in respect of the assets of the business. This amount was arrived at by allowing

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£30,000 as the amount to be paid to the trustees as the value of certain coal contracts. These coal contracts had been entered into by the settlor with certain colliery owners who thereby agreed to deliver certain large quantities of coal at fixed prices. The duration of these contracts varied, but none extended beyond the 31st December, 1915. The chartered accountants appended a note to their balance sheet (Appendix[1], page 7), giving their reasons for considering £30,000 as the fair amount to be paid in respect of these contracts. Since the contracts were entered into the value of coal had risen greatly owing to the war, and the contracts were beyond all question very valuable. The price in the contracts was 14s. a ton, while the market price at the date of the settlor's death was 44s. per ton. The Appellant continued to carry on the business, and in the course of it he used the coal which he got under these contracts for supplying his customers. He claimed to have allowed as against his profits the £30,000 which he had paid to the trustees for the coal so used in the business. This claim is contested by the Crown and forms the subject of the present appeal.

The Second Division of the Court of Session (the Lord Justice Clerk, Lord Dundas and Lord Guthrie) decided for the Crown, Lord Salvesen dissenting. The year ending 31st December, 1915, was divided into two parts for the purpose of the assessment of the profits of the business. The trustees of the deceased, John Smith, junior, were assessed in respect of the profits arising up to the date of his death (7th March, 1915), while the Appellant was assessed in respect of the period subsequent to that date down to the end of the year. It was contended for the Appellant that the £30,000 represented a sum which he had to pay for the coal which he used to supply his customers, and that it could not be excluded from the computation of his profits for the accounting period. For the Crown, on the other hand, it was contended that the assessment of Excess Profits Duty is upon the business as a continuing business, and that as the succession of the son to the business was part of a family arrrangement, he could not make this deduction any more than his father could have made it if he had carried on the business for the whole year, and further, that the £30,000 was capital expenditure which cannot be deducted.

The Excess Profits Duty was introduced by Part III of the Finance (No. 2) Act, 1915, and the decision in this case must depend on the effect of the provisions of that Act. Section 38 (1) provides for the levy as Excess Profits Duty of an amount equal to 50 per cent. of the amount by which the profits of any trade or business in any acounting period exceed by more than £200 the pre-war standard of profits. By Section 40 (1) the profits for Excess Profits Duty are to be determined on the same

[1] Omitted from the present print.

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principles as profits for the purpose of Income Tax, subject to the modifications set out in the Fourth Schedule to the Act, one of which is that the profits are to be the actual profits arising in the accounting period. This same Section 40 (2) provides for the fixing of the "pre-war standard." It is to be ascertained by reference to the average profits of any two of the last three pre-war years to be selected by the taxpayer, provided that if their amount is less than the "percentage standard" the latter shall be the pre-war standard. The percentage standard is the amount of the statutory percentage (6 per cent. for corporations, 7 per cent. in other cases) on the capital of the trade or business as existing at the end of the last pre-war trade year, and provision is made for ascertaining for this purpose the amount of the capital according to Part III of the Fourth Schedule of the Act. It was not disputed, and indeed could not be disputed, on the statements contained in the Case Stated, that the £30,000 represents the fair value of these contracts taken over by the Appellant. If the amount had been in any way unduly inflated it would have been brought to the notice of the Commissioners when the case was heard. Of course, if payment of the £30,000 had been merely a transference by the Appellant from one pocket to the other, the case would have assumed a totally different aspect. For instance, if the Appellant had been the sole beneficiary under his father's will he in fact would have been paid nothing for these coal contracts as he would have been himself the recipient of the price. There was a faint suggestion in the course of the argument for the Crown that the Appellant is one of the beneficiaries who would take under the first and second trusts of the will. The terms of these trusts are not stated. We do not know whether the Appellant would take any substantial interest under these trusts. The point was not mentioned in the Court of Session. If there were anything in it, it should have been raised before the Commissioners, who would have found upon it.

The argument on behalf of the Crown was three-fold: (I) that the Excess Profits Duty is a tax upon a continuous business and that the change of ownership must for this purpose be disregarded; (II) that the deduction sought was in respect of capital expenditure; and (III) that the case is governed by the decision in *The City of London Contract Corporation* v. *Styles*[1]. I take these points in the order in which I have mentioned them.

I. The contention most pressed at the Bar of your Lordships' House on behalf of the Crown was that the Excess Profits Duty is a tax upon the business itself as distinguished from the persons who may from time to time carry it on. It was urged that the business is continuous, and that as these beneficial coal contracts had been acquired in the course of the business when it was carried on by the father, the sum which under the

(1) 2 T.C. 239.

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father's will the son had to give for them could not be allowed as an item in reduction of profits. It was pointed out that if the father of the Appellant had lived until the end of the year the profits assessable to Excess Profits Duty would have been precisely those on which the Crown now seek to charge the Appellant, and it was urged that as the duty is on the business the change in the persons carrying it on should make no difference. It is quite true that the statute imposing the Excess Profits Duty treats the business as continuous for one purpose. As its name denotes, the Excess Profits Duty is charged in respect of the excess of the profits yielded by any business after the outbreak of war as compared with its yield before the war. The business is regarded as remaining the same, although the person by whom it is carried on may have changed. This is consistent with the popular conception of a business as a thing which may exist for a century or more while the persons through whose hands the business passes may have changed over and over again from generation to generation by transmission or transfer, and it cannot be disputed that this conception of the business as an entity which continues is correct. But though for this purpose the business is treated as continuous, the essential incidence of the tax is upon the person by whom it is conducted at the time in question. Just as a rate is imposed upon the occupant in respect of the house, so Income Tax and Super-tax are imposed upon individuals in respect of the business. The yield of the business during any particular period depends upon the amount of profit which is got from it by the person carrying it on for the time being, and this must largely depend upon his personal qualities. The profits are not earned by the business, they are earned by the person who carries it on. The profits of this particular business down to the 7th March were the profits earned by the Appellant's father. After the 7th March they were the profits earned by the Appellant himself. In ascertaining what was the amount assessable to the tax, deductions have to be made, from the gross profits, of all the expenses incurred by the owner for the time being for the purpose of earning these profits. This, indeed, is involved in the very idea of profits. The tax is leviable by Section 38 on the amount by which the profits arising from any trade or business in the accounting period exceed by more than £200 the pre-war standard. The same form of expression " the profits arising from any " trade or business " is adopted in Section 40, Sub-sections (1) and (2). The business makes no profits. The profits are not fruits yielded by a tree spontaneously. They are the result of operations carried on by the owner of the business for the time being and of the ability which he brings to bear upon it.

For a long time the main stress of the argument for the Crown was rested upon Section 45 (2) of the Excess Profits Duty Act. It was contended that the effect of this enactment is that any

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owner for the time being of a business may be assessed to the Excess Profits Duty although he had nothing to do with the business during the accounting period in which these excess profits were earned. It was insisted that this showed that the taxation was imposed upon the business and not upon the owner. I cannot so read the clause. The Excess Profits Duty is charged not on the business but on the person who carried it on in the relevant accounting period. I cannot consider Section 45 (2) as empowering the Commissioners to assess to the duty a person who had no interest in the business during the accounting period in respect of which the assessment is made. The last words of the Sub-section providing for a change of ownership are meant to meet the case of a change of ownership in the course of an accounting period and in such a case to enable the Crown to take the accounting period as ending at the date of the change, and assess the duty on the person who carried on the business at that date. I agree with the view which is expressed by Mr. Justice Rowlatt as to the meaning and effect of this clause (Section 45 (2)) in the case of *Wankie Colliery Company* v. *The Commissioners of Inland Revenue*(1), [1920] 3 K.B. 287. The clause is not mentioned in any of the judgments in the Court of Session and appears to me to have been very properly left out from the pages in the Appendix(2), on which are printed the Sections which are relevant to the case. It is quite clear that if the Appellant's father had lived down to the end of the year 1915 he would have been chargeable on the whole profits for that year. He had made these contracts in the course of the business and their existence, coupled with the fact that coal went up so greatly in value, would have enabled him in the course of the year 1915 to make these very large profits. The coal contracts were his own; he had not to pay £30,000 nor any other sum in order to get the coal under them at 14s. a ton. But the change of the ownership of the business entirely altered the situation. The Appellant was compelled under the trust settlement made by his father to pay £30,000 as the price at which he acquired these contracts, and it was with the coal that he got under them that he carried on the business. Separate computations in respect of the earlier and later parts of the year were necessary. Up to the 7th March the business was the business of the father, from that date to the end of the year it was the business of the son. The profits must be computed in the usual way by comparing the amount got by the sale of the coal with the amount which it cost the owner for the time being to acquire it. Lord Salvesen at the close of his judgment(3) points out with great force to what absurdities the argument for the Crown would

(1) The judgment of Mr. Justice Rowlatt in that case was afterwards appealed against and overruled in the Court of Appeal, [1921] 3 K.B. 344, and the House of Lords, [1922] 2 A.C. 51.

(2) Omitted from the present print. (3) Page 278 *ante*.

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lead :—" Had there been no further rise in price, but the " Appellants had simply realised by sale the price paid by them " (including the £30,000), the result would have been that in " your Lordships' view they must be assessed as for Excess " Profits on this sum, or in other words would have to pay " £18,000 out of capital in name of Excess Profits Duty although " they had not earned a penny of profit. I can find no warrant " for so construing the statute. Its object was not to confiscate " capital used in trading, but to levy a tax on profits made " by trading. Where no profits are made the Act has no " application." If the father had lived he would have made in 1915 a profit of £99,315 19s. 11d. because he already had these highly beneficial coal contracts. How can it be said that the son is to be held to have made this profit when in fact he had made only £69,315 19s. 11d. owing to the circumstances that he had to pay £30,000 to his father's trustee for these coal contracts? If one assessment at the end of the year had been possible, there would have been separate computations for the two parts of the year and the result would have been the same as on the separate assessments which have been made.

II. The second contention for the Crown was that the £30,000 was capital expenditure. It appears to me that this contention fails upon the facts. The contracts purchased all expired by the end of the current year. They covered only the stock required for the year ending 31st December, 1915. It does not appear that the Appellant or his father stored coal for delivery to the purchaser from them. It was more convenient to have the coal sent straight from the colliery to the purchaser. These contracts put at the command of the coal dealer the coal he required for delivery during the year. If the amount of coal which they represented had been in stock in yards belonging to the coal dealer it could not have been disputed that the price paid for it would have been a proper deduction as against the price realised by the re-sale. It can make no difference for this purpose that the coal dealer followed the more convenient practice of having contracts with the collieries and despatching it from the pit's mouth straight to his customers. There is not here any provision of coal for a long time ahead—there is no purchase of a colliery from which the coal is to be extracted—there is merely provision in the only convenient way for the stock required up to the 31st December, 1915, from 7th March, 1915. There is nothing in the nature of capital expenditure in the purchase of the stock wanted for re-sale during the current year. The coal represented by the contracts was circulating capital. It was bought for use in the business and was so used. At one stage of the argument in this House an attempt was made to distinguish the case of contracts for coal from the case of coal already delivered and stored in a coal dealer's yards, and the Lord Justice

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Clerk in part rests his judgment in favour of the Crown upon the distinction between "goods" and "choses in action," such as contracts for coal. This distinction seems to me to be for this purpose untenable. The contracts gave the means of getting coal, and there is no difference for this purpose between having coal stored in your yard and having a contract which enabled you to get it from time to time as you want it. This, indeed, was admitted by the Lord Advocate in argument when he was asked the question specifically by Lord Haldane. If the Crown is entitled to disallow what the Appellant had to pay for these contracts, it would be equally entitled to disallow as a deduction the price paid for coal actually in stock. For the present purpose these coal contracts are not distinguishable from the coal which they represent. What the Appellant had to pay for the coal was the £30,000 which he gave for the contracts which would enable him to get the coal at a comparatively low price, plus the sums which from time to time he paid for particular quantities deliverable at 14s. per ton. The price to him was made up to the 14s. per ton and a proportion of the £30,000 on each delivery. The contracts cannot be regarded either in whole or in part as a fixed asset like a coal mine, they are merely the machinery for getting coal, and the coal which they commanded is the article by the re-sale of which the Appellant made his profit. A contract for delivery of certain quantities of coal at a certain price may be made in consideration of a bonus paid when the contract is entered into, in which case the price to be paid on delivery would be somewhat lower, or it may be constituted simply by the price to be paid on each delivery. In each case the whole amount so paid represents circulating capital, the coal which the purchaser means to re-sell. The purchaser does not re-sell the contracts; he uses them from time to time as he requires coal for re-sale. Where there is no bonus paid, it would not, I suppose, be suggested that there was any element of fixed capital in such contracts. How can the payment of a bonus affect the case? The only difference is that the price which the mine owner is content to take and the coal dealer to pay is, in the first case, made up by a bonus on entering into the contract and the amounts paid on each delivery, while, in the other case, it consists simply in the payment of a larger amount as the price payable on each delivery.

It was further urged by the Crown that Section 159 of the Act of 1842 forbids any deductions on account of diminution of capital employed. This provision, of course, would cover the case of diminution of value of wasting assets, as they are termed. If the owner of a coal business has a coal mine, the coal from which he uses for sale in his business, he would not be entitled to any deduction in respect of the fact that from year to year the mine is being worked out. The whole law on this point was

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investigated in the *Alianza* case(1), [1904] 2 K.B. 666, [1905] 1 K.B. 184, [1906] A.C. 18. It has never before been contended that such a doctrine had any application to the case of goods purchased for re-sale, and re-sold in the course of business. The whole argument for the taxpayer in the *Alianza* case was an attempt to assimilate the *caliche* beds to the case of goods bought for re-sale. The £30,000 cannot be treated as being part of the price paid for the business itself. This is clear from the terms of the trust disposition and settlement. Nothing was to be paid for the goodwill, but the assets were to be taken over at their value to be ascertained. Under these contracts the coal had been bought at 14s. a ton. Coal had risen to 44s. per ton market value, and the £30,000 represented the value of the contracts which gave the right to acquire at 14s. a ton of coal worth 44s. There occurs the following passage in the judgment of the Lord Justice Clerk(2) :—"The Appellants found very strongly " on *Farmer* v. *the Scottish North American Trust*(3), 1912 S.C. " (H.L.) 26, and particularly on Lord Atkinson's judgment at " the foot of page 29, and on *J. and M. Craig (Kilmarnock), " Limited*, 1914 S.C. 338. Of course, these judgments are bind- " ing on us, and I accept and respectfully agree with them. " But they do not appear to me to affect the present case. They " were both before the passing of the Act of 1915, and were " therefore in no way affected by the statutory definition of " capital contained in the Schedule to that Act."

With the utmost respect for the opinion of the Lord Justice Clerk, I cannot see how the application of these authorities is in any way affected by the statutory definition of capital in the Schedule to the Act of 1915. In that Schedule special provision is made with regard to the calculation of capital for the purpose of reaching the percentage standard (Section 40 and Part III of the Fourth Schedule), but the law as to the deductions to be made from gross profits is in no way affected by the statutory definition. In *Craig, Ltd.* v. *The Inland Revenue Commissioners*, 51 S.L.R. 321, pp. 326, 327, and 1914 S.C. 338, pp. 349, 350, Lord Johnston stated very clearly the difference between fixed assets and floating assets. The fixed capital assets comprised, he says, land, leases, works and plant. He goes on :— " But there were other assets of a different kind, namely, the " floating assets consisting of the stocks of material to be worked " up and of the manufactured articles to be sold. With these " the Appellant Company had to commence business, and it " was on the turnover of these and their replacement by further " material and further manufactured articles that the Company " was to make its profit or loss." The whole of the argument which has been addressed to your Lordships on behalf of the Crown on the score of the £30,000 being in the nature of capital

(1) 5 T.C. 60 and 172. (2) Page 276 *ante*. (3) 5 T.C. 693, at p. 705.

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expenditure appears to me to ignore the broad distinction between these two classes of assets, the one class consisting of fixed assets, the other consisting of circulating assets which are bought for the very purpose of being re-sold. I desire in this connection to refer to what was said by Lord Atkinson in delivering the judgment which was adopted by the other members of the House in *Farmer* v. *The Scottish North American Trust, Ltd.*(1), [1912] A.C. 118, and to quote what Lord Herschell said in *Russell* v. *The Town and Counties Bank*(2), (1888) 13 App. Cas., p. 424. He was dealing with the Income Tax, but his language is just as applicable to the Excess Profits Duty:—" The duty is to be " charged upon ' a sum not less than the full amount of the " ' balance of the profits or gains of the trade, manufacture, " ' adventure, or concern '; and it appears to me that that " language implies that for the purpose of arriving at the balance " of profits all that expenditure which is necessary for the purpose " of earning the receipts must be deducted, otherwise you do not " arrive at the balance of profits; indeed, you do not ascertain, " and cannot ascertain, whether there is such a thing as a profit " or not. The profit of a trade or business is the surplus by " which the receipts from the trade or business exceed the " expenditure necessary for the purpose of earning those receipts. " That seems to me to be the meaning of the word ' profits ' " in relation to any trade or business. Unless and until you have " ascertained that there is such a balance, nothing exists to which " the name ' profits ' can be properly applied."

What has to be ascertained for the purpose of Excess Profits Duty in the present case is what profit the Appellant made out of the business during the period from 7th March to 31st December. In this calculation how is it possible to ignore what he had to pay for the coal by the sale of which his profits were made?

III. The third point made on behalf of the Crown was that the present case is governed by the decision in *The City of London Contract Corporation, Limited* v. *Styles*, (1887), in Divisional Court, 3 T.L.R. 512, and in the Court of Appeal, 2 T.C. 239, and 4 T.L.R. 51. It appears to me that the facts in that case differ from those in the present on all points material for the present purpose, and that the decision affords no guidance in this case. The company there was formed to purchase the business of Charles Philips and Co., contractors for public works, and their contracts, plant and materials, and to carry on the business. On assessment to Income Tax the company claimed a deduction of £80,000. They stated that the £80,000 represented part of the purchase money £180,000 paid to C. Philips and Co. for the purchase of the contracts and business on which their profits were realised. The business consisted entirely of partially executed or wholly unexecuted contracts. It was urged for the company that the money had been expended for the purchase of

(1) 5 T.C. 693. (2) 2 T.C. 321, at p. 327.

(Viscount Finlay.)

the business. " My whole contention," said their Counsel, " is " that it was not money invested as capital. You can use your " capital in purchasing contracts from which you derive your " annual profits. It is capital to start with, but then you use " your capital wholly and exclusively for the purposes of your " concern." To this Lord Justice Bowen answered (2 T.C., at p. 243) : " You do not use it ' for the purpose of ' your concern, " which means for the purpose of carrying on your concern, but " you use it to acquire the concern." This answer was conclusive and really sums up the whole case. Lord Esher amplifies this a little. He points out that the £80,000 was part of the purchase money of the business, part of the capital embarked in the business, and that to carry on the business other money must be found to meet the current expenses. The business acquired in that case was the business of carrying on contracts for works, and as part of the business the contracts on hand were purchased. These contracts were for the construction of public works, railways, etc., to be carried out by the contractors. In the present case the business acquired was that of a coal dealer and the contracts were for the supply of coal for re-sale in the course of the business. The business was not to carry on these contracts—they were entered into and afterwards acquired merely as the most convenient way of getting coal to be supplied to customers of the business. The coal which they represented was all wanted for the current year and was all used for delivery during the year. For the reasons which I have already given in dealing with the second contention for the Crown these coal contracts in no way partake of the nature of capital. The £30,000 was not paid as the price of the business but as part of the price of coal with which to carry it on.

For these reasons I think that the decision in the Court of Session was erroneous and should be reversed.

Viscount Cave.—My Lords I have arrived at the same conclusion as the noble and learned Lord on the Woolsack, though by a somewhat different road.

The argument for the Appellants appears to me to be founded upon the assumption that for the purpose of assessment to Excess Profits Duty under the Finance (No. 2) Act, 1915, the profit made by Mr. John Ross Smith in acquiring the coal contracts and carrying on the business during the accounting period from the 7th March to the 31st December, 1915, is to be compared with the trading profits earned by Mr. John Smith, junior, in the selected pre-war period. In my opinion this is not the comparison which the Act requires. The business of John Smith & Son, coal exporters, is one business, carried on by John Smith, junior, for many years before and down to his death on the 7th March, 1915, and thenceforth passing to and continued by his son John Ross Smith ; and it appears to me that in such a case, the case of a continuing business which has changed hands

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during the war, the comparison to be made for the purposes of Excess Profits Duty is a comparison between the trading profits earned in carrying on that business during the accounting period and those produced by the same business in the pre-war period without regard to the change of ownership. This appears from the terms of the Act. Section 38 (1) and Section 40 (2) refer to "the profits of the trade or business." Section 40 (3) provides for a "change in the constitution of a partnership." Section 44 (1) authorises the Commissioners to require a return of profits from any person engaged in the trade or business "or who was "so engaged during any accounting period or pre-war trade "year." Section 45 (2) gives the Commissioners a discretion where there has been "a change of ownership of the trade or "business" either to commence a new accounting period or to allow the accounting period to remain unaltered. All these provisions, as well as Rule 4 of Part II of Schedule IV appear to me to support the conclusion that a business commenced before the war and continued in war-time, though in new hands, is to be treated as one business for the purposes of the Act; and Rule 5 of Part II of the same Schedule, which relates only to the profits earned in the pre-war period, does not afford any valid argument to the contrary. Where the change consists only of the accession of a new partner, I doubt whether anyone would contend that the business is to be treated as a new business and the consideration paid by the new partner for his share brought into the account; and I think that for this purpose a transfer of the business with its goodwill and assets to a new owner stands on the same footing. In either case the business is treated as a going and continuing concern, and the comparison to be made under the Act is a comparison between the trading profits produced by carrying on that concern in the war and pre-war periods respectively. The whole purpose of the Act is to tax the profits of a business so far as enhanced by war conditions and in this connection a change of partners or of owners is irrelevant, so long as the real continuity of the business is maintained. The business is the tree of which the produce in different periods is to be compared.

My Lords, I have dwelt on this point because I think that, if the construction of the Act is that which I indicated, there is an end to this appeal. If the profits which are to be considered are the profits derived from the trading operations of the continuing firm of John Smith and Son, however constituted, then the expenses to be deducted are those, and those only, which were incurred in the course of those trading operations and it is plain that the £30,000, deduction of which is claimed, does not fall within that description. It was wholly unnecessary for any trading purpose of the business (regarded as a continuing concern) that £30,000 or any other sum should be paid for the coal contracts; for those contracts belonged to the firm from the

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time when they were entered into. The £30,000 was not paid by the firm for coal, nor was it paid by the trading firm as such for coal contracts; it was paid by John Ross Smith out of his private pocket as part of an overhead transaction under which the business with its assets and future profits passed into his hands, and it left the trading profits of the firm unaltered. If I buy the crop of an orchard in a particular year for £20 and it sells for £40 my profit is only £20. But the profit of the orchard is £40; and in comparing the produce of the orchard in the year with its produce in another year it is the £40 and not the £20 which must be taken into account. I may add that the contrary view would lead to strange results. If John Smith, junior, had lived until the end of 1915, it is clear that he would have earned the profits assessed and would have had to pay the duty claimed. Can it be that, because he died in March and the business and business assets were transferred to his son upon terms involving a payment of £30,000 for one of the assets, the assessable profit was reduced by that amount? If so, then if John Smith, junior, had lived for another six months and had then died, the contracts being still unperformed, the contracts might then have been valued at £60,000 and the assessable profits would have been reduced by that sum. And upon the same showing, if John Smith, junior, instead of dying, had at some time in 1915 converted the business into a company, the company paying £30,000 or a larger sum for the coal contracts, the company would have been entitled to deduct the whole purchase money paid for those contracts from its assessable profits, and John Smith, junior, if he had held all the shares of the company, would have received the whole profit freed to that extent from Excess Profits Duty. I cannot think that this is the true meaning and effect of the Act.

In any case the figures put forward by the Appellants could hardly be accepted. If, for the purpose of ascertaining the profits during the accounting period, the business is to be treated as a new business commenced by John Ross Smith in March, 1915, it must also be so treated for the purpose of fixing the pre-war standard of profits, and in that case the profits of the accounting period would have to be compared, not with the pre-war figure of £4,137 (for John Ross Smith was not in business before the war), but with a percentage on his capital to be fixed in accordance with the Fourth Schedule, Part II, Rule 4. In my view, however, of the construction of the Act, these are not the figures which have to be taken into account.

For the reasons given above it appears to me that the £30,000 cannot be deducted as claimed by the Appellants, and, accordingly, that this appeal fails and should be dismissed.

Lord Sumner.—My Lords, since the Appellants have abandoned the point as to Mr. Fair's remuneration, there is only one point before your Lordships for decision, namely, whether the

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Appellants are entitled to bring the sum of £30,000, no more, no less, into an assessment in all other respects duly made upon them, as a proper deduction before arriving at profits under the Acts relating to Income Tax and Excess Profits Duty.

The business carried on by John Smith and Son is of a kind fairly familiar. The merchant, who carries on such a business, makes firm forward contracts for long terms to buy coal from collieries, in periodic instalments and at fixed prices, generally f.o.b., and then during the term sells it at a better price, if he can, in greater or in less quantities, choosing his own time and employing his foresight, diligence, and business connections. This system makes the colliery business less irregular and gives the managers a stable programme to work to; it secures to the merchant a fixed basis for a business, which in ordinary times is not very speculative and during the war turned speculation into a certainty " beyond the dreams of avarice ". Such appears to have been the principal business of John Smith and Son in 1914 and 1915. There is or was a converse side, namely, to make forward contracts to supply bunkers to liners or coals to foreign railways and gasworks, and then the merchant must cover himself by current contracts with the pits or to a less extent by buying parcels in the market. Furthermore, by buying f.o.b. and selling c.f. and i. there is a chance of making something out of chartering and freights. Whether this business, either in the hands of father or of the son, included the two latter branches we do not know. One thing, however, is clear. In such a business the colliery despatches the coal by rail to the point of shipment alongside, and the middleman never sees the coal at all. Legally, no doubt, he acts as a conduit, through which the property in the coal flows from the pit to the consumer, but he is hardly conscious of it. He need never have any stock-in-trade. The balance sheet of this firm shows that all the chattels it had were worth only £30 4s. 6d., and they were office chairs and tables. Mr. Smith, the son, bought the business from those representing the estate of Mr. Smith, the father, of whom he was himself one. That he did so in accordance with the provisions of his father's trust disposition and settlement, made some years before, makes no difference, at least none in his favour. The effect of what he did is plain. He bought a business and its assets at a valuation made in manner provided in the settlement. He bought no coals; the business had none, nor any stock-in-trade; nor did he acquire any stock-in-trade in any business sense of the term. He did not pay £30,000; he paid £27,745, as the balance of an account, which showed £30,000 as a fair valuation for the current contracts as between him and the representatives of the estate, agreed to by both and debited on one side of the account. Whether the contracts so valued could have been sold to strangers for that sum we do not know. The valuers evidently had their doubts about it. He did not pay this sum as the consideration

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for an assignment of the benefit of these contracts to himself; he took no assignment. The contracts were presumably in the firm's name and were part of its assets. He acquired the business carried on by his father in that name and with it these assets, and in that capacity, no question being raised, he enjoyed the benefit of contracts, to which he was not a party in name, and to which he was a stranger at the time when they were made. In effect the father died with a number of unfulfilled contracts on his hands, which it had been his business to implement at a profit, and this was what, perhaps among other things, he was then engaged in doing. To the business of further working out these contracts his son succeeded by purchase. £30,000 was the value of an important part of the subject matter of the business, to use a neutral term. It is an accident that the last of the contracts expired during the accounting period. The business carried on was not that of buying and selling contracts but of buying and selling coals, and the contracts, which enabled the seller of the coals to acquire the coals was no more the subject of his trading as a stock-in-trade for sale than a lease of a brickfield would be the subject of a sale of bricks.

My Lords, the *City of London Contract Corporation* v. *Styles*, 2 T.C. 239, was decided 33 years ago. It has never been questioned. It was expressly approved by the Court of Appeal in the *Alianza* case(1), Collins, M.R., greatly relying on it and Lord Justice Stirling actually saying, [1905] 1 K.B., at page 196, that effect could not be given to the argument for the company without departing from that decision. As your Lordships' House confirmed the decision of the Court of Appeal, expressing satisfaction with the reasons given in their judgments, the *City of London Contract Corporation* v. *Styles* has virtually been approved here. Even if I doubted it, which I certainly do not, I should follow it. Tax cases ought not to be unsettled. That decision seems to me indistinguishable from the present case. There the taxpaying company was incorporated to buy as a going concern the business of a firm of contractors, who had been entirely engaged in executing some construction contracts still uncompleted. The company bought this business, including the benefit of these incomplete contracts, and proceeded with the execution of them. In the purchase price was included a sum, ascertainable if not ascertained, for their value. The company claimed that, before their profits from carrying out these contracts could be ascertained, there must be deducted whatever sum represented their value in the price paid for the contractors' business generally. They said, much as has been said in the case, that before profits can be made out of working a contract, the contract has to be got and the payment of its price is the root of the profits. The Court held that this sum was paid with the rest of the aggregate price

(1) 5 T.C. 60 and 172.

to acquire the business and thereafter profits were made in the business; the sum was not paid as an outlay in a business already acquired, in order to carry it on and to earn a profit out of this expense as an expense of carrying it on. The same is true of the Appellants. The whole price paid, in cash or in kind, was a sum employed or intended to be employed as capital in the trade of the company and therefore cannot be deducted in ascertaining profit for Income Tax or Excess Profits Duty.

My Lords, much has been said as to the nature of capital and the right description of this sum of £30,000, assuming it to be capital; I neither think it necessary to attempt to define the term nor to select an appropriate adjective for it. Doubtless Mr. Smith would wisely provide for some replacement of his outlay before flattering himself that he had made this handsome profit, but we are dealing with a firm which, consisting as it did of one person only, was under no legal obligation to keep its accounts in any particular form or even to keep accounts at all. If he paid his taxes and paid his way and kept out of debt, it did not matter what he called the money with which he did it. The only question is whether he can claim to deduct this £30,000 without making a deduction, which the law calls, in the language of the Income Tax Acts, a sum " employed as capital " in his trade, and without making a deduction from the profits or gains from his trade " on account of diminution of capital employed." I think the answer is that he cannot, and so his appeal fails.

Questions put.

That the Judgment of the Court below be reversed.

The Not Contents have it.

That the Judgment of the Court below be affirmed and this Appeal dismissed with costs.

The Contents have it.