No. 1272—HIGH COURT OF JUSTICE (KING'S BENCH DIVISION)—6TH, 7TH AND 13TH OCTOBER, 1941

COURT OF APPEAL—29TH AND 30TH APRIL AND 1ST, 4TH AND 21ST MAY, 1942

HOUSE OF LORDS—22ND, 24TH, 28TH AND 29TH JUNE, 1ST, 2ND, 5TH AND 6TH JULY AND 5TH AUGUST, 1943

ALLCHIN (H.M. INSPECTOR OF TAXES) v. CORPORATION OF SOUTH SHIELDS[1]

Income Tax—Local authority—Liability to account for tax deducted from interest—General rate fund comprising all receipts and all outgoings—Separate accounts for industrial undertakings—Power to apply each year out of the general rate fund a sum, not exceeding the surplus profits of each undertaking, to specified purposes of the undertaking—Whether surplus profits of undertakings available for payment of interest—Income Tax Act, 1918 (8 & 9 *Geo.* V, *c.* 40), *Rule* 6, *Miscellaneous Rules applicable to Schedule D, and Rules* 19 *and* 21, *General Rules applicable to Schedules A, B, C, D and E; South Shields Corporation Act,* 1935 (25 & 26 *Geo.* V, *c.* xcvi), *Sections* 112 *to* 116.

Section 112 *of the South Shields Corporation Act,* 1935, *required that all moneys received by the Corporation, including all money received on account of the revenue of any of the Corporation's undertakings, should be carried to the general rate fund and that all payments and expenses made and incurred by the Corporation in respect of any such undertaking, or in carrying into execution the powers and provisions of the Act or any other Act, whether public or local, should be paid out of the general rate fund. Section* 113 *of the Act provided that the Corporation should keep separate accounts of each of their undertakings, showing as to revenue, on the one side, all income received in respect of the undertaking and, on the other, all expenditure allocated under specified headings, including interest on moneys borrowed for the purpose of the undertaking. Section* 114 *provided that, if in any year the moneys received on account of the revenue of any undertaking exceeded the sums expended for the purposes of the undertaking on certain prescribed lines, the Corporation might apply out of the general rate fund a sum, not exceeding such excess, for various further purposes of the undertaking as specified in the Section. Section* 115 *provided, as regards the electricity undertaking, that the surplus revenue should be applied in creating a fund of working capital, subject to a specified maximum, and, thereafter, in the reduction of the charges for electricity. Section* 116 *repealed, as from* 31*st March,* 1935, *all existing statutory provisions as to the application of the surplus revenues of the Corporation's undertakings.*

During the year 1935 *the Corporation paid interest amounting to* £132,396 *on borrowed money, and on payment deducted Income Tax. In the same year the profits and gains of the Corporation brought into charge to Income Tax amounted to* £91,504. *It was not disputed that the Corporation was liable to account to the Crown for tax upon the difference between these two sums, viz.,* £40,892.

In the accounts for "Housing" and "General" the interest charged amounted to £107,976 *and the taxed income in these accounts to* £51,867, *the difference being* £56,109. *In the accounts of the "Electricity" and "Transport" undertakings the profits and gains charged to tax (viz.,*

[1] Reported (K.B.) 167 L.T. 18; (C.A.) [1942] 2 K.B. 228; (H.L.) [1943] A.C. 607.

£31,859 *and* £7,778 *respectively*) *exceeded the payments on account of interest on moneys borrowed for the purpose of these undertakings* (*viz.*, £19,231 *and* £5,189 *respectively*) *by* £12,628 *and* £2,589 *respectively, being together* £15,217.

On appeal against an assessment for 1935–36 *under the provisions of Rule* 6, *Miscellaneous Rules, Schedule D, in an estimated amount of* £50,000, *the Corporation contended,* inter alia, *that the whole of the interest amounting to* £132,396 *was payable out of the general rate fund; that it could therefore legally pay, and had in fact paid, the interest to the extent of* £91,504 *out of the like amount of profits already charged to tax; and that it was liable to account to the Crown for tax on no more than the difference between these two sums, viz.,* £40,892. *For the Crown it was contended that the Corporation could not lawfully pay interest out of the Corporation's taxed profits in so far as those taxed profits were dedicated by Statute to specific purposes other than the payment of interest; that since the surplus profits of the electricity and transport undertakings were so dedicated, the sum of* £15,217, *being such surplus after payment of interest on moneys borrowed for the purposes of these undertakings, was not available for the payment of interest falling under "Housing" or "General" accounts; and that accordingly the Corporation was accountable for Income Tax on* £56,109. *The Special Commissioners decided that the applications of money which the Corporation was empowered to make under Sections* 114 *and* 115 *had to be made out of the general rate fund but not out of any particular part of it, and that the form of the accounts of the electricity and transport undertakings did not afford evidence that the surplus income from these undertakings had been used or earmarked for any specific purposes; and they held that the Corporation had in the general rate fund a taxed fund of* £91,504, *out of which it could legally have paid, and must be deemed primarily to have paid the interest in question. They accordingly allowed the appeal.*

Held, *that under the provisions of the South Shields Corporation Act,* 1935, *there was nothing illegal in the Corporation paying the interest out of the mixed fund which contained its profits and gains* (Birmingham Corporation *v.* Commissioners of Inland Revenue, 15 T.C. 172, *distinguished*).

Per *Viscount Simon, L.C., the proper interpretation of Rules* 19 *and* 21 *is that annual payments paid in a particular year, which, if the profits or gains brought into charge for that year were large enough, would have been properly payable thereout, are to be treated as having notionally been paid out of the payer's assessed income for that year, and the payer is to be allowed to deduct and retain the tax on the annual payments, provided that the amount so deducted and retained does not exceed the amount of tax payable by him in that year on his assessed income. Any such excess he may not retain but he must account for it to the Crown.*

Result of Attorney-General *v.* Metropolitan Water Board, 13 T.C. 294, *approved, but not the course of reasoning* (*Lord Romer expressing no opinion on this case*).

CASE

Stated under the Income Tax Act, 1918, Section 149, by the Commissioners for the Special Purposes of the Income Tax Acts for the opinion of the King's Bench Division of the High Court of Justice.

1. At a meeting of the Commissioners for the Special Purposes of the Income Tax Acts held on 16th May, 1939, Robert Hood Coulthard, as Treasurer of the County Borough of South Shields, which is hereinafter referred to as "the Corporation", appealed against an assessment for the year 1935–36 made under the provisions of Rule 6 of the Miscellaneous Rules applicable to Schedule D, Income Tax Act, 1918, in an estimated amount of £50,000 in respect of certain sums of interest paid by the South Shields Corporation.

2. In the year the subject of this appeal, the Corporation paid interest on borrowed money amounting to £132,396, and on making such payments deducted Income Tax. In the same year the profits or gains of the Corporation brought into charge to tax amounted to £91,504. The Corporation agreed that it was liable to account to the Crown for tax upon the difference between £132,396 and £91,504, viz., £40,892.

Included in the said amount of £91,504 are the profits of the Corporation's electricity and transport undertakings for 1935–36, amounting respectively to £31,859 and £7,778. After meeting the interest on moneys borrowed for the purpose of these undertakings, there remained of the electricity undertaking's profits the sum of £12,628, and of the transport undertaking's profits the sum of £2,589. These sums together amount to £15,217.

The question for determination is whether the Corporation must be deemed to have paid this interest, amounting to £132,396, primarily out of taxed income so as to entitle them, as against the Crown, to retain the Income Tax deducted by them on payment of the interest to the extent to which they have a taxed fund to cover it.

3. The figures referred to in this Case are set out in the following table which illustrates the parties' contentions.

South Shields Corporation

Income Tax—Interest Liability 1935–36

(1)	*Council's contention*	*Inland Revenue contention*				
	(2) General Rate Fund	(3) Housing Account (1919 Act, houses only)	(4) Electricity Account	(5) Transport Account	(6) Balance—General Account	(7) Total
	£	£	£	£	£	£
(*a*) Payments from which tax has been retained	132,396	41,119	19,231	5,189	66,857	132,396
(*b*) Taxed income—						
(i) Schedule A and B values of properties owned and let	35,752	10,429	—	—	25,323	35,752
(ii) Schedule A values of properties occupied by trading undertakings	20,141	—	18,566	1,522	53	20,141
(iii) Schedule D assessments (after deducting wear and tear)	20,120	—	13,293	6,256	571	20,120
(iv) Taxed interest ..	15,491	3,691	—	—	11,800	15,491
					37,747	
Produce of 1*d.* rate	—	2,011	—	—	*Deduct* 2,011	—
(*c*) Total taxed income ..	91,504	16,131	31,859	7,778	35,736	91,504
(*d*) Interest liability ..	*40,892	24,988	† —	† —	31,121	

* This would be assessed according to the Inland Revenue :

Under Rule 6	£15,904
Rule 21 (Hsg, 1919)	24,988
	£40,892

£56,109—This would be assessed according to the Inland Revenue :

Under Rule 6	£31,121
Rule 21	24,988
	£56,109

† As the taxed items exceed the amounts from which tax has been retained, there is no interest liability.

We were informed that on behalf of the Appellant no point was being taken as regards column (3), the figures for housing account, as upon this item the parties were not in dispute in this appeal.

4. By Section 10 (1) of the Rating and Valuation Act, 1925, rating authorities are required to keep, in substitution for any rate fund existing at the time when the Act came into operation, one rate fund to be termed "the "general rate fund"; and references in any Act or document to the borough fund, or the district fund, or any other rate fund affected by the Section, are to be construed as references to the general rate fund.

5. By Section 185 of the Local Government Act, 1933, all the receipts of the council of a borough are to be carried to the general rate fund, and all liabilities of the council are to be discharged out of that fund.

6. Section 112 (1) of the South Shields Corporation Act, 1935 (hereinafter referred to as "the Act of 1935")—a copy of which Act is annexed hereto, marked "A", and forms part of this Case[1]—enacts as follows:—

> "Notwithstanding anything contained in any other Act or Order all "moneys received by the Corporation whether on capital or revenue "account including (but without prejudice to the generality of this "provision)—
>
> "(*a*) all money received on account of the revenue of any of the "Corporation undertakings; and
>
> "(*b*) interest and other annual proceeds received on the investments "forming part of any fund accumulated for the redemption of "debt or working capital or as a reserve renewals repairs "depreciation contingency insurance consolidated loans capital "reserve or other similar fund (including any interest payable "to any such fund in pursuance of the section of this Act of which "the marginal note is 'Use of moneys forming part of sinking "'and other funds');
>
> "shall be carried to and form part of the general rate fund and all "payments and expenses made and incurred by the Corporation in "respect of any such undertaking or in carrying into execution the powers "and provisions of this or any other Act whether public or local (including "interest on moneys borrowed by the Corporation and all sums required "by law to be paid or transferred or which the Corporation may determine "to pay or transfer to any such fund as is referred to in paragraph (*b*) "of this subsection) shall be paid or transferred out of the general rate "fund Provided that an amount equivalent to the interest and other "annual proceeds as aforesaid shall (subject in the case of any of the "said funds to any prescribed limit on the amount thereof) be credited "in the accounts of the fund of the investments on which the same is "received."

7. As required by Section 113 of the Act of 1935 the Corporation keeps separate accounts showing the position of its various undertakings and the details specified by the said Section, e.g., on the one side all income and on the other side all working expenses, including interest on borrowed moneys, etc., etc. Each of the principal undertakings of the Corporation has its own bank account, but the receipts from these undertakings all flow into the general rate fund and all payments and transfers are made out of the general rate fund as required by Section 112.

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[1] Not included in the present case.

8. By Section 114 of the Act of 1935 it is provided, *inter alia*, that if in any year the moneys received by the Corporation, on account of the revenue of any undertaking, exceed the moneys expended by the Corporation for certain defined purposes of such undertaking, the Corporation may apply out of the general rate fund a sum not exceeding the amount of the excess for various further purposes of the said undertaking, which are then specified in the Section.

9. By Section 115 of the Act of 1935 provision is made for the application of the surplus electricity revenue :

(i) in creating a fund of working capital (up to a specified maximum) for the electricity undertaking, and

(ii) in reducing the charges for electricity supplied by the Corporation.

10. An abstract of the Corporation's accounts for the year 1935–36 is attached hereto in a bound volume, marked " B ", and forms part of this Case(1).

11. Evidence was given by the Respondent that the reserve fund of the electricity undertaking amounted, at all times material hereto, to the one-twentieth of the aggregate capital referred to in Section 115 (2) (ii) (*a*) of the Act of 1935 : that the reserve fund of the transport undertaking had not reached the one-fourth of the outstanding debt referred to in Section 114 (1) (*c*) (ii) of the Act of 1935 : and that in the year 1935–36 no part of the profits of the electricity undertaking was applied in reduction of the general rate.

The accounts of each undertaking were prepared by the Respondent and issued by him under statutory authority. These accounts were submitted to the finance committee who passed them. The responsibility for the allocation of the profit and the form of the accounts rested with the Respondent.

12. On behalf of the Respondent it was contended :—

(*a*) That the whole of the interest payable by the Corporation in 1935–36 and amounting to £132,396 was payable out of the general rate fund.

(*b*) That the general rate fund was a " mixed fund " consisting partly of taxed and partly of untaxed receipts, the taxed receipts being the sum of £91,504 representing profits of the Corporation brought into charge to tax.

(*c*) That it was lawful to pay the aforesaid interest, to the extent of £91,504, out of the like amount of profits already charged to tax.

(*d*) That the aforesaid interest, to the extent of £91,504, was in fact so paid or must be deemed to have been so paid ; and no earmarking of this interest in the Corporation accounts against an equivalent amount of taxed profits is necessary to enable the Corporation to retain the tax deducted from such interest.

(*e*) That the accounts of the Corporation do not shew that any part of the profits brought into charge in 1935–36 had been applied for purposes other than the payment of interest ; and that if it were necessary (which was not admitted) the said accounts could be rewritten as between the Corporation and the Revenue so as to shew all taxed profits transferred to the general rate fund and there available for payment of interest.

(*f*) That the Corporation was assessable to Income Tax for 1935–36 only on the difference between £132,396 and £91,504, viz., £40,892.

13. On behalf of the Appellant it was contended :—

(1) Not included in the present print.

(*a*) That the interest in question could not lawfully be paid out of the taxed profits of the Corporation to the extent that those taxed profits were dedicated by Statute to specific purposes other than the payment of interest.

(*b*) That the Respondent had failed to prove that the interest in question was, in fact, paid out of taxed profits or must be deemed to have been so paid.

(*c*) That the accounts shewed that it was not the profits of the various undertakings which were paid into the general rate fund, but the whole of the receipts of the Corporation. It was only when the accounts of the electricity and transport undertakings were drawn up that it was known whether any profits emerged. Any such profits were allocated by Statute in a set manner and were not wholly available for the payment of interest on in relief of rates.

(*d*) That even if the accounts were rewritten to shew all taxed profits transferred to the general rate fund, and all interest paid out of the general rate fund, the taxed profits would nevertheless not be available for the payment of interest.

(*e*) That the Corporation was, therefore, assessable on £56,109, which was the difference between £132,396 interest paid under deduction of tax, and £76,287 taxed income remaining after the statutory charges payable out of the taxed income had been met, and being the amount of £91,504 referred to in paragraphs 2 and 3 of the Case less the amount of £15,217, which is not available for the payment of interest.

(*f*) That as the above-mentioned sum of £56,109 includes interest on the housing account amounting to £24,988 assessable under Rule 21, about which in this appeal there is no dispute, the assessment under Rule 6 should be reduced to the difference between £56,109 and £24,988, viz., £31,121.

14. We, the Commissioners who heard the appeal, having quoted the figures set out in paragraphs 2 and 3 of this Case, gave our decision as follows :—

"By Section 112 of the South Shields Corporation Act, 1935, all the "moneys received by the Corporation must be carried to and form part of "the general rate fund and all payments by the Corporation must be made "out of the general rate fund. The general rate fund is a 'mixed fund' and "in making payments of interest out of this 'mixed fund' the Corporation "must be deemed to have paid primarily out of taxed income unless it appears "from the evidence that the payments were not in fact paid out of taxed "income or could not be so paid because the taxed income had been used "for or dedicated to some other purposes.

"The applications of money, which the Corporation is empowered to "make under Sections 114 and 115 of the Act of 1935, have to be made out "of the general rate fund, but not out of any particular part of it, and the "form of the transport and electricity accounts does not, in our opinion, "afford evidence that the actual surplus income from these undertakings has "been used or earmarked for any specific purposes. We hold, therefore, that "the Corporation possessed in the general rate fund a taxed fund of £91,504 "out of which it could legally have paid the interest in question, and we "further hold that they must be deemed to have paid the interest primarily "out of the taxed income. The appeal therefore succeeds and we remit the "case to the parties in order that the assessment may be adjusted to the "correct sum."

We were subsequently informed that the correct sum assessable under Rule 6 in conformity with the above decision was £15,904, and we reduced the assessment accordingly.

15. The Appellant immediately after the determination of the appeal expressed to us his dissatisfaction therewith as being erroneous in point of law and in due course required us to state a Case for the opinion of the High Court pursuant to the Income Tax Act, 1918, Section 149, which Case we have stated and do sign accordingly.

MARK GRANT-STURGIS, } Commissioners for the Special Purposes of the
N. ANDERSON, } Income Tax Acts.

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

11th January, 1941.

The case came before Lawrence, J., in the King's Bench Division on 6th and 7th October, 1941, when judgment was reserved. On 13th October, 1941, judgment was given in favour of the Crown, with costs.

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

JUDGMENT

Lawrence, J.—This is an appeal by the Crown against the decision of the Special Commissioners holding that the South Shields Corporation are entitled to deduct Income Tax from payments of interest on their bonds, under Rule 19 of the General Rules, although the undertaking in respect of which such bonds were issued had not earned profits which had suffered tax sufficient to cover such interest but the Corporation had in their general rate fund other profits derived from their other undertakings which had suffered tax. The position is shown in the table set out in the Case.

The Corporation seek to apply their excess revenue on their electricity and transport accounts, namely, £12,628 and £2,589, towards the payment of interest on their housing account. I understand it to be common ground between Counsel that the real question is whether it was lawful for the Respondents to apply the excess revenue arising upon one of their undertakings in payment of interest upon bonds issued for the purposes of another of their undertakings. In any event, in my opinion, that this is the real question, results from the decision of the House of Lords in *Sugden* v. *Leeds Corporation*, 6 T.C. 211, especially pages 257, 258 and 259. This question depends upon the construction of Sections 112, 113 and 114 of the South Shields Corporation Act, 1935.

The Respondents contend that, as their only fund is the general rate fund, into which all receipts must go and out of which all payments must come, they are entitled to apply any sums in that general rate fund towards the payment of any of their interest liabilities and are therefore entitled to apply any sums which have borne tax to the discharge of any of their liabilities. They say, further, that Section 113 deals only with accounts and is merely designed to show the financial position of their various undertakings, and that Section 114 was merely intended to prevent their applying more than the excess arising from their several undertakings for the purposes therein specified.

(Lawrence, J.)

The Attorney-General, on the other hand, contends that Section 114 must be read as meaning that the Respondents can apply their excess revenue only upon the subjects specified in Sub-section (1) (*a*) to (*c*), and that if the Respondents can apply such excess revenue upon any of their liabilities it would have been quite unnecessary to specify the objects mentioned in Sub-section (1) (*a*) to (*c*). He says further that Sections 111 to 115 all contemplate that the accounts of the various undertakings should be kept most carefully separate and distinct, and that it would be a remarkable construction to put upon Section 114 that the Corporation have power to apply any part of their excess revenue arising upon one undertaking to make up a deficit upon another and that if they cannot do that they cannot apply such excess towards paying liabilities unconnected with the undertaking in question.

It is true that Section 114 uses the words " may " and " if they think fit ", and the Corporation must therefore have a discretion as to whether they apply their excess revenues to the purposes specified, but I find it difficult to understand why the objects specified in Sub-section (1) (*a*) to (*c*) were mentioned if the Corporation have power to apply their excess revenues as they please, and I think it may very well have been the policy of the Legislature that any excess revenue of the Corporation's various undertakings, if not applied to the purposes specified, should be retained and so operate in relief of rates.

Upon the whole I have come to the conclusion that the contention of the Crown is correct and the appeal must be allowed with costs.

It is unnecessary for me to deal with the subsidiary question whether in fact the Corporation have applied profits which have suffered tax to payment of the liabilities in question.

An appeal having been entered against the decision in the King's Bench Division, the case came before the Court of Appeal (Lord Greene, M.R., du Parcq, L.J., and Lewis, J.) on 29th and 30th April and 1st and 4th May, 1942, when judgment was reserved. On 21st May, 1942, judgment was given unanimously against the Crown, with costs, reversing the decision of the Court below.

Mr. J. Millard Tucker, K.C., Mr. Maurice FitzGerald, K.C., and Mr. Terence Donovan appeared as Counsel for the Corporation, and the Solicitor-General (Sir David Maxwell Fyfe, K.C.) and Mr. Reginald P. Hills for the Crown.

JUDGMENT

Lord Greene, M.R.—I am authorised by **du Parcq, L.J.,** to say that he has read the judgment which I am about to deliver and that he agrees with it.

In the year 1935–36 the Appellants paid in interest on borrowed money the sum of £132,396. Part of this money had been borrowed for purposes connected with their electricity and transport undertakings and part for their general purposes. On making the payments they deducted tax in the usual way. In the same year their profits or gains brought into charge (i.e., as assessed) to tax amounted to £91,504. They admit their liability to account to the Crown for the tax upon the difference, namely, £40,892. In the sum of £91,504 there are included the profits of the electricity and transport undertakings of the Appellants as assessed to tax for the year. After deducting from these assessed profits a sum equal to the interest on moneys borrowed for the purpose of the undertakings, there remains the sum of £12,628 in respect of the assessed profits of the electricity undertaking and the sum of £2,589 in respect of the assessed profits of the tramway undertaking.

(Lord Greene, M.R.)

The Appellants contend that these two sums must be deemed to have been applied towards payment of the interest which they paid during the year on moneys borrowed for their general purposes and that they are entitled to retain the corresponding amount of tax.

The Crown disputes this claim and contends (1) that profits of the undertakings could not lawfully be applied in payment of interest on money borrowed for purposes of the Corporation other than those connected with the undertakings themselves; (2) that in any event, on the facts, the surplus profits of the undertakings were not so applied, but were dedicated by the Appellants exclusively to the purposes of the undertakings.

The Special Commissioners decided in favour of the Appellants, but their decision was reversed by Lawrence, J. I am of opinion that the Special Commissioners came to the right conclusion and that their decision should be restored.

Apart from certain notorious difficulties as to the true meaning and operation of Rules 19 and 21 of the General Rules applicable to the five Schedules, the question turns ultimately upon the construction of certain Sections in the South Shields Corporation Act, 1935. But in order to understand the relevant provisions of that Act it is necessary to examine briefly the law as it existed before the Act in relation to the receipts and expenditure of the Appellants and in particular the profits of the two undertakings.

The public general Act by which the Appellants were governed in respect of these matters was the Local Government Act, 1933. By Section 185 of that Act all receipts of the council of a borough are to be carried to the general rate fund of the borough, and all liabilities falling to be discharged by the council are to be discharged out of that fund. Special provision was, however, made to secure that existing statutory rules as to the application of surplus revenue arising from undertakings should be preserved. This provision is contained in Section 194 of the Act, which says that nothing in that Part of the Act is to be deemed to require or authorise a local authority to apply or dispose of such surplus revenue otherwise than in accordance with the provisions of any enactment or statutory order relating to the undertaking.

The effect of this was that, notwithstanding that all receipts and expenditure were to be paid into and out of the general rate fund, a borough council could not apply the surplus revenue of any of its undertakings for any purpose not authorised by the Statute or Order governing the undertaking. If, for example, a council had surplus revenue from an electricity undertaking which was only applicable for the purposes of the undertaking, it could not apply it in payment of interest on money borrowed for its general purposes. Consequently, it could not claim to retain tax deducted from such interest on the ground that the interest was or must be deemed to have been paid out of the taxed income of the undertaking (cf. *Sugden* v. *Leeds Corporation*, 6 T.C. 211).

Before the passing of their Act of 1935 the rights and obligations of the Appellants in respect of the application of the surplus revenue of their electricity and transport undertakings were governed by statutory provisions. It is not necessary to set these out, since it is conceded by Mr. Tucker, on behalf of the Appellants, that, had it not been for the Act of 1935, it might have been illegal for the Appellants to apply the surplus revenues with which this appeal is concerned in payment of interest on loans not raised for the purposes of the undertakings, with the result that the principle of *Sugden's* case would have governed the present controversy. I shall not stop to consider whether or not this would have been the case, but I will assume it. On that basis the question which we have to decide is whether the position has been altered by the Act of 1935.

(Lord Greene, M.R.)

The case of the Appellants is that all previously existing restrictions upon the application of the surplus revenues of the two undertakings were swept away by certain Sections of their Act of 1935 which it is now necessary to consider.

The first of these Sections is Section 112, which provides that, notwithstanding anything contained in any other Act or Order, all moneys received by the Corporation, including in particular all money received on account of the revenue of any of the Corporation undertakings and all interest on reserve and other funds, are to be carried to and form part of the general rate fund ; and that all payments and expenses in respect of any such undertaking or the other activities of the Appellants shall be paid out of the same fund.

Section 113 provides for the keeping of separate accounts in respect of each undertaking and for the form in which such accounts are to be kept.

Section 114 empowers the Appellants in certain events to apply out of the general rate fund a sum not exceeding the amount of the specified excess revenue of any undertaking in any year to certain specified purposes connected with the undertaking, including the provision of a reserve fund and deals with the application of such reserve fund.

Section 115 contains special provisions for the electricity undertaking in substitution for certain directions contained in the Electric Lighting Order of 1891 under which that undertaking is carried on.

Section 116 repealed the existing statutory provisions governing the application of the revenues of the undertakings and the method of keeping their accounts.

These Sections are long and complicated, and I have not thought it necessary to set them out in detail. It is, however, right to observe that they are drafted with great care and skill with the obvious intention of securing to the Appellants the advantages in respect of Income Tax which they now claim. In my opinion they are effective for that purpose.

The effect of the repeal contained in Section 116 of the Act was to abolish all existing statutory regulations and restrictions as to the application of the surplus revenues of the undertakings. It is contended on behalf of the Crown that Sections 112 to 115 reimposed those restrictions or, rather, imposed corresponding restrictions in relation to the application of the surplus revenues of the undertakings so as to make it still illegal for the Appellants to apply them in payment of interest on general purpose loans ; in other words, that the law for present purposes is unchanged and the principles of *Sugden's* case [1] still apply. An examination of the language of the Sections shows this contention to be unfounded and, accordingly, there is no scope for the operation of Section 194 of the Local Government Act, 1933.

The effect of the relevant Sections of the Act of 1935 may, I think, be summarised as follows. All receipts and expenditure must be paid into and out of the general rate fund ; but for the purpose of the internal accounts of the borough, separate accounts showing the specified particulars must be kept in respect of each undertaking. This was obviously necessary, since if the only account kept had been that of the general rate fund it would have been impossible to ascertain the financial position of the undertakings. But the obligation to keep these accounts imposes no sort of restriction on the Appellants as to the way in which they are to deal with the profits of the undertakings, any more than would be the case with an ordinary trading company which, for purposes of convenience, treated different branches of its undertaking as separate entities for accountancy purposes.

[1] 6 T.C. 211.

(Lord Greene, M.R.)

Section 114 has as its marginal note the words " Application of revenue of " undertakings ", and the same phrase appears in the preamble to the Act. I cannot attach to this phrase the importance which Counsel for the Crown suggest that it bears. It is in fact a misdescription of the contents of the Section. The Section gives no directions as to the application of revenue as such. It merely empowers the Appellants, when there is a surplus, to apply sums out of the general rate fund for specified purposes of the undertaking which shows the surplus. It is impossible to say of sums so applied that they are the profits of the undertaking; they are no more the profits of the undertaking than they are the proceeds of the rates. The actual money represented by the surplus revenue of the undertaking does, of course, go to swell the amount standing in the general rate fund; but its identity is lost and it cannot for any relevant purpose be identified with sums which, under Section 114, the Appellants elect to apply out of the general rate fund for the purposes of the undertaking. Moreover, there is nothing compulsory about the application and it is not true to say that there is anything in the Section which makes it illegal for the Appellants to apply the profits of their undertakings for any purpose, including the payment of interest, to which their moneys can otherwise lawfully be applied. There is no need to deal specially with Section 115, which carries the matter no further.

The result down to this point is as follows. At the date when the interest was paid, the general rate fund was made up of moneys which in part were derived from untaxed income (rates) and in part from the profits of the undertakings for the year in question. Out of that fund the interest was paid. The profits of the undertakings for the year had been or would in due course be subjected to tax, although the profits as assessed to tax would not be the same in amount as the actual profits shown by the accounts—they were in fact less.

It is convenient here to refer to the tests laid down by Lord Atkinson in *Sugden's* case, 6 T.C., at page 264, which, in the Crown's contention, must be satisfied before the Appellants can succeed. Lord Atkinson says that before the taxpayer can retain the tax deducted, he must be able to answer affirmatively two questions: (1) Has the interest been in fact paid or must it in the circumstances of the case be taken to have been paid out of profits or gains brought into charge, i.e., out of the so-called " taxed fund "; (2) Was it lawful to pay them out of the fund?

For the reasons which I have given I am of opinion that the second of these questions must be answered in the affirmative. It is in the case of local authorities that this question usually arises. The reason lies in the peculiar constitution of these bodies. Unlike the ordinary trading company, their income is in part derived from a source not liable to tax, i.e., rates. That part which is derived from their undertakings is taxable. The Legislature has in the past imposed restrictions upon the application of the profits of their undertakings with the result that those profits had to be kept distinct from their other receipts, just as if a local authority had been several legal entities instead of one. Once those restrictions are removed, as in the present case, the authority ceases to be divided into separate compartments in this way and all its receipts become lawfully applicable for all its purposes. It is thus placed in precisely the same position in this respect as any other person.

It is upon the first of Lord Atkinson's questions that the alternative contention of the Crown is based. It is said that when the accounts of the undertakings are examined it will be found that the profits which they earned in the year 1935–36 were all in fact applied for the purposes of the undertakings themselves and that no part of them was in fact applied in payment of the interest with which we are concerned.

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This argument is, in my opinion, based upon a misconception as to the meaning of payment out of a taxed fund. On a previous occasion I ventured to point out some of the difficulties which that and similar phrases appeared to me to occasion—*Paton* v. *Commissioners of Inland Revenue*, 21 T.C. 626, at pages 647 *et seq.* That I had good ground for doing so appears from the opinion of Lord Macmillan delivered later in the same year in *Central London Railway Co.* v. *Commissioners of Inland Revenue*, 20 T.C. 102, at page 143, in which the other members of the House of Lords concurred.

Much of the obscurity which surrounds this matter is due to a failure to distinguish the two senses in which the phrase " payment out of a fund " may be used. The word " fund " may mean actual cash resources of a particular kind (e.g., money in a drawer or at a bank) or it may be a mere accountancy expression used to describe a particular category which a person uses in making up his accounts. The words " payment out of " when used in connection with the word " fund " in its first meaning connote actual payment, e.g., by taking the money out of the drawer or drawing a cheque on the bank. When used in connection with the word " fund " in its second meaning, they connote that, for the purposes of the account in which the fund finds a place, the payment is debited to that fund, an operation which, of course, has no relation to the actual method of payment or the particular cash resources out of which the payment is made.

Thus, if a company makes a payment out of its reserve fund—an example of the second meaning of the word " fund "— the actual payment is made by cheque drawn on the company's banking account, the money in which may have been derived from a number of sources. The phrase " reserve fund " only has a meaning as indicating the item in the company's accounts to which it decides to debit the payment. It will be seen, therefore, that to speak of an actual payment being made out of a fund in the second sense is really a misuse of language. A fund in the second sense is merely an accountancy category ; it has a real existence in that sense, but not in the sense that a real payment can be made out of it as distinct from being debited to it. Unless these two meanings of the phrase " payment out of a fund " are kept distinct, much confusion of thought must ensue. A real payment cannot be made out of an imaginary fund—per Lord Macmillan in the *Central London Railway* case, 20 T.C., at page 146.

In applying these considerations to the requirements of Rule 21 that the interest must have been payable and paid out of profits brought into charge to tax, it will be seen that the word " profits " cannot (except in the possible case of income taxed at the source) be construed as indicating the cash resources out of which the payment is in fact made. The word can only be used in the accountancy sense of a fund of profits ascertained for the purposes of an account between the taxpayer and the Revenue. As the result of taking that account the taxpayer is deemed to have in his hands a fund of taxed profits up to, but not exceeding, the amount of the assessment.

Accordingly, it becomes necessary for the purpose of giving effect to Rules 19 and 21 to draw up a further account as between the taxpayer and the Revenue. On the one side is entered the interest paid, on the other side the " taxed fund " which may consist of profits as assessed to tax under different Schedules. The taxpayer is not entitled to bring in on this side of the account a taxed fund if the profits in respect of which the relevant assessment is made cannot lawfully be applied in payment of the interest. Subject to this, in the absence of special circumstances, to which I will refer later, the taxpayer is, in my opinion, entitled to treat the interest entered on one side of the account as having been paid out of the items of taxed profit

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entered upon the other side. In the accountancy sense, he has so paid it, since as between him and the Revenue he is entitled to have the account drawn in this way and to debit his payments to the taxed fund.

It follows from this that (again apart from special circumstances) the question out of what cash resources was the payment made, is entirely irrelevant. A trader may spend the whole of his profits for the year in buying himself a house, with the result that he has to borrow money in order to pay his mortgage interest. This does not disentitle him from saying that, as between himself and the Revenue, he is entitled to debit the interest paid to the fund representing the amount in which his profits for the year are assessed. To hold otherwise would be to make nonsense of Rules 19 and 21. Nor can the way in which, for his own convenience he chooses to keep his accounts deprive him of this right. If he carries on two businesses and chooses to keep their accounts distinct, he may in those accounts show the profits of one business as having been wholly applied in buying capital assets for that business and charge the whole of the interest which he is liable to pay to, for example, a reserve account in the other business representing profits of past years. But in taking the account as between himself and the Revenue he is entitled to treat the assessed profits of the first business as available for the payment of the interest. To speak of this as rewriting the trader's accounts is a misdescription. His domestic accounts stand, and there is not any question of rewriting them. The account which is drawn up between himself and the Revenue is a totally different account drawn up for totally different purposes and the figure representing taxed profits which appears in it is a statutory and (except in the case of profits taxed at source) not an actual figure.

I have thought it desirable to explain at some length the principles which appear to me to underlie questions of this nature. I might perhaps have contented myself with citing some of the passages in the numerous authorities in which the matter has been discussed, notably the speech of Lord Atkinson in *Sugden's* case(1) and that of Lord Macmillan in the *Central London Railway* case(2) to which I have already referred; but the nature of some of the arguments presented to us showed that the subject is still regarded as wrapped in considerable obscurity and that must be my excuse.

If I have correctly grasped these principles, it follows that, in the present case, the fact that the Appellants in their domestic accounts have chosen, without any legal compulsion, to show the profits of their undertakings for the year as having been wholly applied for the purposes of the undertakings does not in any way disentitle them from saying that the interest has been or must be deemed to have been paid *pro tanto* out of the taxed fund at which these profits are quantified by assessment. Once it appears that the profits in respect of which the assessment is made are in their nature legally applicable for the purpose of paying the interest, they are entitled to claim that it was in fact paid or must be deemed to have been paid out of those profits as assessed so far as they will go. They are in precisely the same position as the trader with two businesses to whom I have referred, the only difference being that part of their income, namely, that derived from rates, is not liable to tax. This, however, does not entitle the Crown to say that the interest must be deemed to have been paid out of the rates. It is, in fact, as true to say that the rates have been applied for the purposes of the undertakings, leaving the profit available for payment of the interest.

I have referred to the fact that special circumstances may exist which will produce a different result. I do so by reason particularly of two decisions

(1) 6 T.C., at p. 258. (2) 20 T.C., at p. 143.

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upon which Counsel for the Crown placed great reliance. In my opinion, however, they have nothing to do with the present case. The circumstances in each case were very special. In the *Central London Railway's* case, 20 T.C. 102, the railway company had statutory powers to do what it would not otherwise have been entitled to do, namely, charge the interest on certain debenture stock to capital. This power it elected to exercise. The figure at which its profits were assessed to tax was large enough to cover the interest and it claimed to be entitled to treat the interest as having been paid out of those profits. It was held that it was not entitled to do so.

Now, the fact that the company chose to charge the interest to capital might at first sight appear to be a mere matter of domestic accountancy. Had it charged the interest to revenue, as it was perfectly entitled to do, it could unquestionably have retained the tax; but by taking the course which it did it set the amount of its profits free for payment of dividend. Its action, as Lord Macmillan said (at page 151), was much more than a mere matter of domestic accountancy. He went on to explain why this was so. The effect of charging the interest to capital was to swell the dividend fund upon the distribution of which the company retained a larger amount of tax than they would have retained if the interest had been charged to revenue and the dividend fund in consequence reduced. They could not at one and the same time claim to enjoy this larger retention and treat the interest as chargeable, as between themselves and the Crown, to revenue account.

The other case is *Corporation of Birmingham* v. *Commissioners of Inland Revenue*, 15 T.C. 172. There the corporation's expenditure on a housing scheme, including interest on loans raised for the purposes of the scheme, exceeded the receipts and the corporation claimed to treat the interest on the loans as having been paid out of its taxed income. For the purpose of claiming the Exchequer subsidy, the interest paid on the housing loans was brought in by the corporation at the gross and not the net figure. Lord Buckmaster (at page 209) pointed out that " the accounts were prepared for a department " of the Crown to whom, acting through another department, the tax was " payable, and, so regarded were prepared upon the footing that the tax was " unpaid, with the result that either the creditor was still liable for the tax " or that, if it had been deducted, it was retained to satisfy his liability in " that respect." The decision turned entirely on the special nature of the Exchequer subsidy and the action of the corporation in basing its claim for subsidy on the assertion that it was out of pocket to the extent of the gross amount of the interest.

But these cases, as I have said, turned on very special facts. In the present case, when the facts are analysed and the Sections of the Act of 1935 correctly construed, no special circumstances appear which would prevent the Appellants from claiming that the interest must be treated as having been paid *pro tanto* out of their taxed income.

Lawrence, J., appears to have taken a different view as to the construction of the Act of 1935. My reasons for differing from him sufficiently appear.

In my opinion, the appeal succeeds and the decision of the Special Commissioners must be restored.

Lewis, J.—I have had an opportunity of reading the judgment which the Master of the Rolls has just delivered; I agree with it and I have nothing to add.

Lord Greene, M.R.—The appeal will be allowed with costs here and below.

Mr. Tucker.—If your Lordship pleases.

Mr. Hills.—I am instructed, my Lords, to ask for leave to appeal in this case to the House of Lords.

Lord Greene, M.R.—Mr. Tucker, we have all considered this matter and, subject to anything you may have to say, we think it is a proper case for leave to appeal.

Mr. Tucker.—My Lord, I do not think I can resist that. The only question in my mind is the question of costs, whether your Lordships might think that this is one of the cases in which there may be a condition as to costs.

Lord Greene, M.R.—No; we do not think this is a case for any Order as to the costs.

Mr. Tucker.—I do not desire to press it, my Lords.

The Crown having appealed against the decision in the Court of Appeal, the case came before the House of Lords (Viscount Simon, L.C., and Lords Russell of Killowen, Macmillan, Wright and Romer) on 22nd, 24th, 28th and 29th June and 1st, 2nd, 5th and 6th July, 1943, when judgment was reserved. On 5th August, 1943, judgment was given unanimously against the Crown, with costs, confirming the decision of the Court below.

The Solicitor-General (Sir David Maxwell Fyfe, K.C.) and Mr. Reginald P. Hills appeared as Counsel for the Crown, and Mr. J. Millard Tucker, K.C., Mr. Maurice FitzGerald, K.C., and Mr. Terence Donovan for the Corporation.

JUDGMENT

Viscount Simon, L.C.—My Lords, this is the appeal of the Crown against the unanimous decision of the Court of Appeal (Lord Greene, M.R., du Parcq, L.J., and Lewis, J.) reversing the judgment of Lawrence, J., upon a Case stated by the Commissioners for the Special Purposes of the Income Tax Acts. The matter arises upon an assessment to Income Tax for the year 1935–36 made upon the Respondent as Treasurer of the County Borough of South Shields, hereinafter referred to as the Corporation, under the provisions of Rule 6 of the Miscellaneous Rules applicable to Schedule D of the Income Tax Act, 1918.

In substance, the question at issue is whether certain annual interest paid by the Corporation during the fiscal year 1935–36 was paid, or should be deemed to be paid, out of profits or gains brought into charge to Income Tax, with the result that the Corporation is not required to hand over to the Crown the Income Tax which it has deducted when paying such interest.

Stated in figures, as set out in the Case, the question may be thus propounded. In the year 1935–36 the Corporation paid interest amounting in all to £132,396 on borrowed money and on making such payments deducted Income Tax at the standard rate. For the same year the profits or gains of the Corporation were assessed to tax at £91,504. (The language of the Case is that in the year 1935–36 "the profits or gains of the Corporation brought "into charge to tax amounted to £91,504", but it is agreed between the parties that this refers to the assessment for the year, not to the actual profits or gains made in the year, for a portion of the total is the figure of Schedule D assessments which are based on the figures of actual profits of the preceding year.) The Corporation admitted that it was liable to account to the Crown for tax deducted from interest in respect of so much of the £132,396 as exceeded £91,504, namely £40,892, but claimed to retain the rest. The

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Appellant, however, contends that there is a further sum of tax deducted from interest which must be handed over, namely, tax on £15,217, arrived at as follows. The profits of the Corporation's electricity undertaking as assessed for 1935–36 amounted to £31,859, while the interest paid in that year on moneys borrowed for the purpose of that undertaking amounted to £19,231. The difference between these two figures is £12,628. Similarly, the profit of the Corporation's transport undertaking as assessed for 1935–36 amounted to £7,778, while the interest paid in that year on moneys borrowed for the purpose of this undertaking amounted to £5,189. The difference is £2,589; and this sum, together with the sum of £12,628 mentioned above, makes up the £15,217, the handing over of tax on which is in dispute.

The Appellant contends that the balance of profit of each of the undertakings arrived at as above is not to be treated as a contribution to meet the interest on loans not raised for the particular undertaking, or as having been available for such a purpose, and that such interest could not lawfully be paid out of the profits of the undertaking inasmuch as the profits of that particular undertaking were dedicated by Statute to specific purposes other than the payment of such interest. In support of these contentions the Appellant refers to the well-known decision of this House in *Sugden* v. *Leeds Corporation,* [1914] A.C. 483, and especially to the two tests formulated by Lord Atkinson in his speech at page 506 (6 T.C. 211, at page 264).

The Respondent, on the other hand, relies upon certain Sections of the South Shields Corporation Act, 1935, which, as he submits, make it lawful to use any part of the profits of the electricity and transport undertakings for the purpose of paying interest on moneys borrowed for general purposes, and contends that the balance of profit of each of these undertakings, as measured by the assessment of them to Income Tax, should be deemed to have been used in paying an equivalent part of the total interest in the year of charge.

Before examining the South Shields Act of 1935, it is desirable to summarize the scheme of Income Tax collection which is now contained in Rules 19 and 21 of the General Rules and was formerly provided by Section 102 of the Income Tax Act, 1842, Section 40 of the Income Tax Act, 1853, and Section 24, Sub-section (3), of the Customs and Inland Revenue Act, 1888. The former Sections were the subject of analysis by Lord Macnaghten and Lord Davey in the decision of this House ordinarily referred to as the first *London County Council* case (*London County Council* v. *Attorney-General,* [1901] A.C. 26; 4 T.C. 265). The present provisions take their place without any change of substance, and the general effect may be stated under three heads, though, as will hereafter appear, there remains lurking in the language of the scheme a difficulty which does not seem to have been clearly apprehended and faced in some of the earlier authorities on this subject, but which came to the surface in *Attorney-General* v. *Metropolitan Water Board,* [1928] 1 K.B. 833; 13 T.C. 294.

The three heads under which the existing scheme of collection of Income Tax embodied in Rules 19 and 21 may be stated are as follows:—

(*a*) A person liable to pay any yearly interest of money, annuity or any other annual payment to a recipient is not entitled to deduct this payment in arriving at his profits or gains to be assessed and charged with Income Tax. If the amount is payable and paid out of his profits or gains, he is assessed on a sum which includes such payments, while the recipient is not directly assessed in respect of the amount at all. Consequently, the Crown gets from the payer both the tax at the standard rate which would otherwise be due from the recipient of the annual payment and the tax due from himself in respect of what is left of his profits and gains after the payment is made.

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(*b*) If the annual payment is payable and paid out of his profits and gains, the payer is *entitled* to deduct from the payment he makes to the recipient Income Tax at the current rate, and the recipient is bound to allow the deduction upon receipt of the residue and to treat the payer as acquitted of liability to him in respect of the amount thus deducted. By this means, the payer recoups himself for the tax which he has paid or will pay on the annual payment.

(*c*) If and in so far as the annual payment is not payable and paid out of profits or gains brought into charge, the person making the payment is *bound* to deduct from it Income Tax at the current rate and to account to the Crown for the amount deducted. In effect, the payer in such a case acts as collector for the Crown of the tax due from the recipient. The requirement that the recipient must allow the deduction and treat the payer as acquitted of liability in respect of this amount is not repeated in Rule 21, but must be implied.

Subject to the difficulty which I am about to state, this scheme seems reasonably clear. The receiver of the annual payment is chargeable in respect of annual profits or gains arising from " all interest of money, annuities, " and other annual profits or gains " under Schedule D, 1 (*b*), but under Rules 19 and 21 the tax is collected at the source before payment to him. If the payment is made out of the profits or gains of the payer, he is entitled to reduce his payment by the amount of the tax, but the Legislature is not concerned to insist that he shall do so, as the Crown will get the tax whether he does so or not. If and so far as the payment is not made out of profits or gains, the Legislature insists that the payer must deduct tax and account for it, for otherwise the Crown might not receive it.

The difficulty that remains to be solved arises from the fact that the figure at which profits or gains are assessed under Cases I and II of Schedule D are not normally the actual profits or gains of the year of charge, but a figure, formerly arrived at by averaging the profits or gains of three preceding years, and now arrived at by taking those of the preceding year. Yet, if an annual payment in any year is made " out of profits or gains " this suggests that it is made out of actual profits or gains and not out of a conventional figure arrived at from the past which is taken to represent them for taxing purposes. What, then, is the proper meaning to put on the phrase " payable wholly " out of profits or gains brought into charge " in Rule 19, and on the phrase " not payable, or not wholly payable, out of profits or gains brought " into charge " in Rule 21? To give an illustration, if in a given year £900 of interest is paid away out of profits or gains and in that year the actual profits or gains of the payer are £1,000, while in the previous year they were £800, can the interest be regarded as wholly paid out of profits or gains brought into charge? The judgments of the Court of Appeal in *Attorney-General* v. *Metropolitan Water Board,* [1928] 1 K.B. 833; 13 T.C. 294, and in particular the judgment of Lawrence, L.J., in that case, appear to take the view that the phrase the " profits or gains brought into charge " in a given year means the amount of the assessment for that year. If so, I cannot agree with this construction; though I agree with the result at which the Court of Appeal in that case arrived. The " profits or gains brought " into charge " must, in my view, mean the actual profits of the year calculated with such deductions, additions, or allowances as the Income Tax law prescribes—the £1,000 in my illustration.

The matter is put beyond doubt, in my opinion, by observing that in Rule 19 these profits or gains brought into charge " shall be assessed and " charged with tax ": they cannot, therefore, be themselves the assessed figure. But I think the true solution of the difficulty is to be found by treating Rule 19, while predicating a payment of interest out of actual profits,

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as measuring these actual profits by the figure (whether larger or smaller, or the same) of assessment of them to tax—that is, in my illustration, the interest is deemed to be paid out of £800. If, in the following year, actual profits fell off, they would nevertheless be measured by the figure of £1,000. This amounts to saying that tax is set off against tax, the tax deducted on paying interest against the tax charged for the same year on an assessed figure of profits or gains from which the interest payment has not been deducted. This construction is in accordance with the result—though not with all the reasoning—in *Attorney-General* v. *Metropolitan Water Board*(1). It is in line with Lord Davey's observation in *London County Council* v. *Attorney-General,* [1901] A.C., at page 46; 4 T.C., at page 301: " the mortgagor " cannot, of course, retain against the Crown more income tax than he has " paid." It is implied in Lord Macnaghten's statement in *Attorney-General* v. *London County Council,* [1907] A.C. 131, at page 135; 5 T.C. 242, at page 260: " Speaking generally, all income is chargeable, but chargeable only " once. Income is brought into charge at its source, and the burden is then " distributed among the recipients of the income who bear their share in " just proportion." I agree with Lawrence, L.J., in the *Metropolitan Water Board* case, [1928] 1 K.B., at page 852; 13 T.C., at page 311, that " under " the provisions of Rules 19 and 21 no taxpayer can retain against the Crown " any more income tax deducted by him in any year of assessment than he " has himself paid or become liable to pay to the Crown for that year." This, of course, includes Income Tax suffered by deduction at the source. The purpose behind the Rules is to avoid double taxation, as Lord Macmillan pointed out in *Central London Railway Company* v. *Commissioners of Inland Revenue,* [1937] A.C. 77, at page 81; 20 T.C. 102, at page 145.

In the *Central London Railway Co.'s* case this House abstained from either affirming or dissenting from the decision of the Court of Appeal in *Attorney-General* v. *Metropolitan Water Board,* but I think we must now indicate a final view on the construction placed on the words " profits or gains brought "into charge " by the judgments in that case. As I have already indicated, in my view the conclusion in the *Metropolitan Water Board* case should be approved, but the course of reasoning by which the Court of Appeal arrived at that decision calls for correction. The phrase " profits or gains brought " into charge " in a given year cannot, I think, itself mean the figure of assessment in respect of them reached when those profits or gains have been assessed and charged, but while interest may in proper circumstances be treated as payable and paid out of these actual profits or gains, the extent to which Income Tax deducted from such interest may be set off against Income Tax charged on those profits or gains is to be ascertained by reference to the assessment made upon the latter.

It is to be noted that the view I have set out above is the view accepted by both sides in drawing up the Case Stated, which provides the subject-matter for the present appeal. The Solicitor-General, if I understood him rightly, however, claimed to go further, and contended that a taxpayer who had paid interest in a particular year out of his profits or gains could not retain Income Tax deducted from such interest unless both the actual profits or gains of the year and the sum at which they were assessed were as large as the interest paid. This would be getting the best of both worlds with a vengeance. This contention that a taxpayer cannot be treated as paying out of profits or gains unless he has enough to cover the payment both in the figure of his actual profits in the year and also in the figure of assessment of those profits is, as far as I know, novel, and I do not find anything in the Income Tax Act to support it.

(1) 13 T.C. 294.

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The proper interpretation of Rules 19 and 21 is to hold that annual payments paid in a particular year, which, if the profits or gains brought into charge for that year were large enough, would have been properly payable thereout, are to be treated as having notionally been paid out of the payer's assessed income for that year, and the payer is to be allowed to deduct and retain the tax on the annual payments, provided that the amount so deducted and retained does not exceed the amount of tax payable by him in that year on his assessed income. Any such excess he may not retain but he must account for it to the Crown.

The remaining question is whether, in view of the South Shields Corporation Act, 1935, it was legal to use profits from the electricity and transport undertakings in order to pay interest on moneys borrowed for general purposes. This question resembles the second question formulated by Lord Atkinson in *Sugden's* case, [1914] A.C., at page 506; 6 T.C., at page 264. I entirely agree with the Master of the Rolls in his illuminating judgment that the effect of Sections 112, 113, 114, 115 and 116 of the South Shields Act is to make it legitimate for the Corporation to do what they claim to have done. The effect of the repeal contained in Section 116 is, as Lord Greene said, "to abolish all existing statutory regulations and restrictions as to the "application of the surplus revenues of the undertakings(1)." The result of Sections 112 to 115 is not to reimpose restrictions so as to make the decision in *Sugden's* case applicable. There is no scope, in view of the repeal in Section 116, for the operation in this case of Section 194 of the Local Government Act, 1933.

The result is that there would be nothing illegal in the Corporation paying this interest out of the mixed fund which contains its profits or gains. Neither is there anything in the present case which goes to show that they have precluded themselves by inconsistent action (as was the case in *Birmingham Corporation* v. *Commissioners of Inland Revenue*, [1930] A.C. 307; 15 T.C. 172) from being treated as paying the interest out of profits or gains brought into charge. The Corporation claims to be so treated, and the claim is justified. I adopt in its entirety the exposition of the Master of the Rolls on this part of the case, in which he points out how limited is the assistance for the solution of this matter which can be derived from an examination of the way in which the Corporation's accounts are made up and recorded.

In my opinion the appeal fails, and I move that it be dismissed with costs.

My Lords, my noble and learned friend **Lord Wright** authorises me to say that he concurs in this opinion.

Lord Russell of Killowen.—My Lords, I also concur in the opinion which has just been delivered by the Lord Chancellor, and I desire to add nothing thereto.

Lord Macmillan (read by Lord Russell of Killowen).—My Lords, in the fiscal year 1935–36 the Corporation of South Shields paid a sum of £132,396 by way of interest on borrowed money. In the same year the Corporation paid Income Tax on an assessed income of £91,504. The question is: To what extent can the £132,396 be said to have been payable out of the £91,504? The Crown admits that to the extent of £76,287, but no more, the £132,396 was payable out of the £91,504; the Corporation maintain that the £132,396 was payable out of the £91,504 to the whole extent of that sum. The controversy is thus confined to the difference between £91,504 and

(1) *See* page 454 *ante*.

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£76,287, namely £15,217, on which last-mentioned sum the Crown claims that it is entitled to Income Tax, in addition to the tax on £91,504.

Stated in figures that is the problem presented for solution. In law, the problem is to ascertain to what extent the interest paid by the Corporation in the year of assessment was payable out of profits or gains brought into charge to tax in that year within the meaning of Rule 19 of the General Rules applicable to all Schedules under the Income Tax Act, 1918.

The admission by the Crown, and indeed the contentions of both parties, imply that in construing the Rule the relevant profits or gains are not the profits or gains of the taxpayer as actually earned in the year of assessment, but the profits or gains of the taxpayer as they are assessed for Income Tax purposes in that year. This is tantamount to an acceptance by both parties of the result of the decision in the case of *Attorney-General* v. *Metropolitan Water Board,* [1928] 1 K.B. 833; 13 T.C. 294, though not necessarily of all the reasoning on which that decision was based.

I think that in the end one is driven to adopt this construction as the only practical way of making the Rule work. In the case of the *Central London Railway Company* v. *Commissioners of Inland Revenue,* [1937] A.C. 77; 20 T.C. 102, I discussed at length the difficulties to which the wording of the Rule gives rise owing to the failure of the draftsman to appreciate that a real payment cannot be made out of notional profits. I need not traverse again that painful maze. Bluntly, I do not think that a logical solution is possible of an illogical problem. One can console oneself verbally by saying that the profits brought into tax in any year are the actual profits of that year (though there may be none) as measured by the sum at which the profits of that year are assessed. But it still remains true that actual payments cannot be made out of assessed income.

Accepting, however, as I do, that for practical purposes the relevant figures to be considered in the first place in the case of each assessment year are (1) the amount of interest paid by the taxpayer on borrowed money in paying which the taxpayer has deducted tax, and (2) the sum on which the taxpayer has himself paid tax in that year, I recognise that the matter does not necessarily end there. The taxpayer may have income not subject to tax as is the case with the Corporation of South Shields, which has a large income from rates, and the payment of interest may have been made out of a general account to which all receipts, taxable and untaxable, are carried. This case has been described as that of payment from a mixed fund. The cardinal difficulty emerges again. How can there be a mixed fund composed partly of actual receipts, for example from rates, and partly of notional profits or gains? The practical solution is to deem the interest to have been paid out of the profits as assessed unless there is any legal impediment to so deeming.

This brings me to the last point, which is the point expressly raised in the present case. The figure at which the taxpayer's profits for the year have been assessed and on which he has paid tax, having been ascertained, is that figure further examinable? The Crown contends, and the authorities justify the contention, that it is, and that the taxpayer cannot be deemed to have paid interest out of profits which cannot legally be applied in payment of that interest or which he has by his own deliberate actings debarred himself from so applying. Again, the cardinal difficulty reappears in another form. If it is illegal for a taxpayer to use any particular part of his profits for the payment of interest on certain borrowed money, it can only be the actual payment out of actual profits that is illegal. How can illegality attach to

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payments not actually made but only deemed to be made out of a notional fund?

The resources of judicial construction, already severely strained, must once more be invoked. Payments which could not lawfully be made out of actual profits cannot be deemed to have been made out of corresponding notional profits. The profits of the taxpayer as assessed for a particular year, although they may differ widely from his actual profits for that year, are nevertheless compiled from actual figures. If an ingredient of the profits as assessed is derived from a source which precludes the application of that ingredient to the payment of interest on borrowed money or with regard to which the taxpayer has so acted as to preclude himself from being deemed to have so applied it, then to that extent I think that the taxpayer is debarred from saying that he has paid the interest in question out of profits or gains brought into charge to tax.

In the present case the assessed profits of the Corporation include profits derived from their electricity and transport undertakings. No doubt these are in fact the profits of the preceding year, but they are the profits which the law attributes to the year of assessment or by which it measures the profits of the year of assessment. So far as the assessed profits of these undertakings are deemed to have been applied to the payment of interest on money borrowed for the purposes of these undertakings, no question arises. But the assessed profits include surplus profits over and above the interest due on money borrowed for the purposes of these undertakings. The Crown says that these surplus profits are so dedicated by Statute, or otherwise have by the Corporation itself been deliberately so applied, as to preclude the Corporation from maintaining that they can be deemed to have been applied in payment of the Corporation's general liabilities on interest account.

On this part of the case I am so entirely content with the answer which the Master of the Rolls has given to the Crown's contention that I have nothing to add. I am of opinion that on this point, which is the real point expressly raised by the Stated Case, the Crown fails. The appeal should accordingly be dismissed.

Lord Romer.—My Lords, the Special Commissioners, Lawrence, J., and the Court of Appeal have very properly dealt with this case upon the footing that the case of *Attorney-General* v. *Metropolitan Water Board,* [1928] 1 K.B. 833; 13 T.C. 294, by which they were all bound, was rightly decided. The result of this has been that neither in the Case Stated nor in the judgments is there to be found the figure of the actual profits or gains accruing to the South Shields Corporation from all sources in the year of assessment 1935–36, or the balance of profit accruing to them in the year from their electricity and transport undertakings, respectively, after deduction in each case of the interest paid in the year on moneys borrowed for the purposes of such undertakings. All we are told is that the profits or gains from all sources in that year were assessed at £91,504, and that the balances of the sums at which the profits of the two undertakings for the year had been respectively assessed, after making in each case the deduction to which I have just referred, amounted together to the sum of £15,217. But the parties appearing before your Lordships were agreed, and your Lordships were accordingly informed, that for the year in question the actual profits or gains of the Corporation from all sources were not less than £91,504, and the balances of the actual profits from the two undertakings amounted together to not less than £15,217. In these circumstances I am of opinion that the Court of Appeal's decision in the present case was right whether the decision in the *Metropolitan Water Board* case was right or wrong, a question upon which I prefer to express no

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opinion. For I am satisfied for the reasons given by the Master of the Rolls, to which I cannot usefully add a single word, that the whole of the interest on borrowed money paid by the Corporation in the year 1935–36 could properly be paid out of the profits or gains of the Corporation for that year brought into charge to tax so far as such profits or gains were sufficient for the purpose, and that such interest ought, as between the Corporation and the Revenue, to be treated as having been so paid in fact. I would therefore dismiss the appeal.

Questions put:

That the Order appealed from be reversed.

The Not Contents have it.

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

The Contents have it.

[Solicitors:—Solicitor of Inland Revenue; Speechly, Mumford & Craig, for Harold Ayrey, Town Clerk, South Shields.]