VOL. XXX—PART VI

No. 1407—High Court of Justice (King's Bench Division)—
21st and 22nd May and 6th June, 1946

Court of Appeal—10th, 11th and 12th March and 2nd April, 1947

House of Lords—19th, 20th, 22nd and 23rd April and 14th July, 1948

(1) Smith's Potato Estates, Ltd. *v*. Bolland (H.M. Inspector of Taxes) (1)

(2) Smith's Potato Crisps (1929), Ltd. *v*. Commissioners of Inland Revenue (1)

Income Tax, Schedule D, and Excess Profits Tax — Deduction — Expenses in connection with Excess Profits Tax appeal to Board of Referees—Income Tax Act, 1918 (8 & 9 *Geo.* V, *c.* 40), *Schedule D, Cases* I *and* II, *Rule* 3 (*a*); *Finance* (*No.* 2) *Act,* 1939 (2 & 3 *Geo.* VI, *c.* 109), *Sections* 14(1) *and* 18.

The Appellant Company in the first case (the Estates Company) was a wholly owned subsidiary of the Appellant Company in the second case (the Parent Company) and was formed to purchase and work an estate. In computing the Estate Company's profits for Excess Profits Tax purposes for the chargeable accounting period ended 31*st March,* 1941, *the Commissioners of Inland Revenue decided that only* £3,500 *of the remuneration of* £6,486 14*s. of the manager of the estate should be allowed. The Appellants were of opinion that if this decision were upheld, similar decisions, which it would then be almost impossible to resist, would be made for subsequent chargeable accounting periods. For these subsequent periods there would be a right to recover from the manager the additional Excess Profits Tax resulting from the decisions and it was thought that the Parent Company, being a public company, might be bound to exercise this right. Such action might seriously prejudice the Company's future by causing the loss of the services of the manager. The Appellants therefore appealed against the decision of the Commissioners of Inland Revenue to the Board of Referees, who held that* £5,800 *of the manager's remuneration was allowable. In prosecuting the appeal the Estates Company incurred expenditure of* £622 *on legal costs and accountancy fees.*

On appeals to the Special Commissioners against an assessment to Income Tax under Case I *of Schedule D on the Estates Company and an assessment to Excess Profits Tax on the Parent Company in respect of its subsidiary's profits, the Appellants contended that the said expenditure of* £622 *was allowable as a deduction in computing*

(1) Reported (K.B.) [1946] 2 All E.R. 284; (C.A.) [1947] 1 All E.R. 704; (H.L.) [1948] A.C. 508.

profits for Income Tax and Excess Profits Tax purposes. The Crown contended that the case was indistinguishable in principle from Allen *v.* Farquharson Brothers & Co., 17 T.C. 59, *and that the Appellants' motive in prosecuting the appeal was irrelevant. The Special Commissioners dismissed the appeals.*

Held (*Viscount Simon and Lord Oaksey dissenting*), *that the expenditure was not an allowable deduction for Income Tax and Excess Profits Tax purposes.*

CASES

(1) *Smith's Potato Estates, Ltd,* v. *Bolland* (*H.M. Inspector of Taxes*)

CASE

Stated by the Commissioners for the Special Purposes of the Income Tax Acts under Section 149 of the Income Tax Act, 1918, 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 22nd June, 1945, Smith's Potato Estates, Ltd. (hereinafter called "the Estates Company") appealed against an assessment to Income Tax under Case I of Schedule D in the estimated sum of £50,000 for the year 1944-45 (based upon the profits of the Estates Company's trading year ended 31st March, 1944).

2. The Estates Company is a subsidiary company of Smith's Potato Crisps (1929), Ltd. (hereinafter called "the Parent Company"), and for the chargeable accounting period of twelve months ended 31st March, 1941, the Parent Company was assessable to Excess Profits Tax in respect of the profits of the Estates Company.

Section 32 of the Finance Act, 1940 (which relates to Excess Profits Tax), provides:—

"(1) In computing the profits of any trade or business for any "accounting period, no deduction shall be allowed in respect of "expenses in excess of the amount which the Commissioners" (i.e., the Commissioners of Inland Revenue) "consider reasonable "and necessary, having regard to the requirements of the trade "or business, and, in the case of directors' fees or other payments "for services, to the actual services rendered by the person concerned.

"(2) Any person who is dissatisfied with a decision of the Com-"missioners under this section may appeal to the Board of "Referees."

The general manager of the Estates Company is Mr. George Frederick Young (hereinafter called "Mr. Young"). He is not a director of either Company.

In the said year ended 31st March, 1941, Mr. Young's remuneration from the Estates Company totalled £6,486 14*s.* 0*d.*

In computing the profits of the Estates Company for assessment to Excess Profits Tax for the said chargeable accounting period ended 31st March, 1941, the Commissioners of Inland Revenue, acting under Section 32 of the Finance Act, 1940, decided that no deduction should be allowed in respect of Mr. Young's said remuneration in excess of £3,500, being the amount which the Commissioners considered reasonable and necessary, having regard to the requirements of the trade or business and to the actual services rendered by Mr. Young.

The Parent Company and the Estates Company appealed to the Board of Referees against this decision, and that Board held that £5,800 out of the said sum of £6,486 14*s.* 0*d.* was deductible.

The Estates Company incurred legal and accountancy costs of £622 10*s.* 11*d.* in the preparation and prosecution of that appeal.

The sole question at issue in the present appeal is whether these costs are an admissible deduction in computing the profits of the Estates Company for the purpose of assessment to Income Tax.

The circumstances of Mr. Young's association with the Estates Company, the nature of his services and the events antecedent to the prosecution of the said appeal are set forth in the following paragraphs.

3. The Estates Company is a wholly owned subsidiary of the Parent Company, a large public company whose main business is the manufacture and sale of Smith's potato crisps. The Parent Company has for many years been the largest single consumer of potatoes in the country, and its requirements of potatoes of a particular kind and quality have been about 40,000 tons a year.

In 1936 the directors of the Parent Company were becoming increasingly concerned to ensure their supplies of potatoes, and they had the opportunity of acquiring the Nocton estate in Lincolnshire which for many years previously had produced, in addition to other general farm products, a large quantity of potatoes suitable for the Parent Company's business, and had been developed under the direction of the previous owner (one of the best known farmers and potato growers in the country) on highly organised and industrialised lines. It had about 27 miles of light railway connecting the fields and a large and fully equipped grading mill and other appurtenances.

4. The Estates Company was formed as a subsidiary of the Parent Company in order to acquire the Nocton estate. It purchased the estate in April, 1936, at a price of £250,500 payable in cash, and the stock, machinery, tenant rights, etc., at a price determined by valuation. The purchase was financed by the Parent Company subscribing for 200,000 shares of 5*s.* each (the entire issued capital of the Estates Company), and by an issue by the Estates Company to the public of £350,000 4 per cent. first mortgage debenture stock, which was guaranteed by the Parent Company. The total area of the property purchased was 6,944 acres.

5. Mr. Young had been the manager of the estate for the vendor for many years, and as the vendor's reason for desiring to sell the estate was that his health was failing, Mr. Young was largely concerned in conducting the negotiations for sale.

None of the directors of the Parent Company or the Estates Company had any knowledge of farming, and they were naturally anxious that the Estates Company should secure Mr. Young's services as general manager, because he had not only a great knowledge and experience of farming but also a special knowledge of this particular estate. Indeed they would not have committed themselves to the purchase of the Nocton estate if they had not been sure of obtaining his services. At the same time they were uncertain as to what profits the estate would earn, and they desired to have the amount of Mr. Young's remuneration based mainly on results. Mr. Young was confident that large profits would be made, especially by reason of the fact that the Estates Company could have

an assured outlet for its potatoes, and was willing to take remuneration in the form of a salary of £1,500 per annum plus a commission at the rate of ten per cent. on any amount by which the Estates Company's net profit for each year exceeded a sum equal to 5 per cent. on the sum of £400,000 (the initial share and loan capital of the Estates Company) and on any additional share or loan capital which might be subsequently introduced. These terms were embodied in an agreement in writing dated 3rd April, 1936, for a period of 5 years, and thereafter until determined by either party giving six months' notice. The agreement also provided, that in arriving at the net profits of the Estates Company for the purposes of the agreement, any potatoes sold by the Estates Company to the Parent Company should be deemed to have been sold at the price of £3 10*s.* 0*d.* per ton, irrespective of the prices at which they were actually sold. A copy of the agreement is included in the printed statement of facts and grounds prepared for the purpose of the said appeal to the Board of Referees, which is annexed hereto, marked "A", and forms part of this Case(1).

6. Up to and including the year 1939 the anticipated large profits were not realised, and indeed the farming profits made were barely sufficient to pay the debenture interest and overhead charges. During those years Mr. Young earned no commission under the agreement. These results were due to causes outside Mr. Young's control and were mainly due to the activities of the Potato Marketing Board and to a substantial rise in the cost of production of farm products generally (the adverse effect of which, from Mr. Young's point of view, was accentuated by the fixed price to be taken under his agreement for potatoes sold to the Parent Company), and those years were unfavourable for farming generally.

7. Mr. Young frequently expressed his dissatisfaction with the manner in which conditions had gone against him and the terms of his agreement had operated, and made it clear that, if the Estates Company desired him to continue in its service after the expiration of the first five years of his agreement, there would have to be substantial revisions of the agreement in his favour. The directors of both the Parent Company and the Estates Company were well satisfied with the manner in which Mr. Young managed the estate, and the ownership and management of the estate by the Estates Company was of great advantage to the Parent Company in giving it an assured supply of potatoes, especially as market conditions were difficult during this period.

8. Since the original purchase substantial additions have been made to the estate by further purchases of farms and equipment, one of the additions being a farm which was purchased for about £6,500 by the Parent Company and let to the Estates Company. These additions have substantially increased Mr. Young's duties and responsibilities.

9. In the year ended 31st March, 1940, the profits of the Estates Company improved substantially, and the directors decided to recognise Mr. Young's efforts by paying him a bonus of £2,000, though he was not entitled to this sum under his agreement, as (apart from a doubt as to whether Excess Profits Tax was deductible in calculating profits under the agreement) the provision fixing the price to be taken for the potatoes sold to the Parent Company was by this time operating very unfairly against

(1) Not included in the present print.

Mr. Young owing to the substantial increase in the cost of production of potatoes since the agreement was entered into.

10. In September, 1940, Mr. Young gave notice to terminate his agreement on 1st April, 1941, and intimated to the directors that he would not be prepared to renew it unless substantial variations were made in his favour in the former agreement. Negotiations then took place for a new agreement to take effect as from 1st April, 1941.

Mr. Young asked for the following substantial variations of the former agreement:—

(1) that the provision fixing a notional price of £3 10*s*. 0*d*. per ton for potatoes sold to the Parent Company should be deleted;

(2) that is should be made clear that the net profits, for the purpose of arriving at the amount of commission to be paid to him, were to be calculated before deducting Excess Profits Tax;

(3) that the Estates Company should insure him against accident in the normal and usual execution of his duties for £10,000 in case of his death and half salary in case of total disablement;

(4) that the altered basis of computing net profits for the purposes of calculating commission should be applied as from 1st April, 1940.

After negotiations lasting until February, 1941, it was agreed between the Estates Company and Mr. Young that in computing the Estates Company's net profit for the purpose of the agreement:—

(1) potatoes sold to the Parent Company should be deemed to be sold at the minimum control prices imposed by the Government from time to time and appropriate to the varieties of potatoes sold to the Parent Company, or (when there were no such minimum control prices in force) at the lowest fair market price for the appropriate varieties of potatoes on the first day of each month;

(2) Excess Profits Tax should not be deducted.

Point (3), mentioned in the preceding paragraph, was not agreed to, but it was agreed that the altered basis of computing net profits should apply as from April, 1940.

11. A written agreement (a copy of which is also included in the said statement of facts and grounds annexed hereto(1)) was accordingly executed on 4th March, 1941, whereunder Mr. Young agreed to act as general manager of the Estates Company for a further period of six years from 6th April, 1940, and thereafter until the agreement should be determined by either party giving six months' notice in writing. Under this agreement the salary payable to Mr. Young is £1,500 per annum, and the commission payable to him is at the rate of 10 per cent. on the amount by which the net profits of the Estates Company for each year or other period for which its accounts are made up (computed so as to give effect to points (1) and (2) mentioned in the preceding paragraph) exceed 5 per cent. per annum on the sum of £400,000 plus any additional capital introduced into the Estates Company by the issue of shares or by loan from the Parent Company.

12. The directors of the Parent Company and of the Estates Company were and are of the opinion that Mr. Young would not have agreed to continue in the Estates Company's service after 1st April, 1941, on any

(1) Not included in the present print.

terms less favourable to him than those which were in fact agreed upon. In agreeing to those terms the directors of both Companies necessarily bore strongly in mind not only Mr. Young's proved ability and knowledge of farming but the special knowledge and experience which he had in managing this particular estate. They felt that during wartime it would be difficult, if not impossible, to find an adequate substitute for him, and that probably no one in the country could be found who could get from the estate the production results which Mr. Young could get. The estate is not an ordinary farm, not only is it very large (over 8,000 acres) but it is highly industrialised and specially organised. It does not produce potatoes only, because it is not possible to grow potatoes on more than a comparatively small proportion of the area in any one year: the area on which potatoes are grown in any one year does not exceed about 1,500 acres.

In addition to potatoes the estate produces wheat, barley, oats, sugar beet and other crops; it also has a considerable stock of cattle and sheep and about 2,000 pigs. It is of great importance in the national interest, as well as in the interest of both Companies, that the maximum production should be obtained from the estate, and the directors felt that maximum production could only be obtained by Mr. Young because he alone had an intimate and special knowledge of this particular estate as well as a great general knowledge and experience of farming. The results in fact achieved by Mr. Young, even allowing for the favourable effect of wartime prices, have been very striking.

The entire responsibility for the management of the estate rests on Mr. Young: none of the directors of either Company has any knowledge of farming.

13. On or about 16th December, 1940, Mr. Young was offered by Mr. William Parker of Babbingly Hall, Kings Lynn, Norfolk, the position of manager of Mr. Parker's farming estates at a salary of £5,000 per annum plus an interest in results. Mr. William Parker is a well-known agriculturalist who farms on a scale comparable with that of the Estates Company. Mr. Young did not accept it, being then in the course of his negotiations as to a revision of his terms of employment with the Estates Company, with whom he preferred to remain, provided those terms were satisfactory to him.

14. The details of Mr. Young's remuneration for the year ended 31st March, 1941, were:—

	£	s.	d.
Salary	1,500	0	0
Bonus	50	0	0
Commission	4,936	14	0
	£6,486	14	0

His total remuneration for the year ended 31st March, 1937, and subsequent years were:—

Year ended 31st March, 1937	£1,479
" " " " 1938	£1,500
" " " " 1939	£1,550
" " " " 1940	£3,550
" " " " 1941	£6,486 (as above)

Year ended 31st March, 1942	... ...	£6,198
" " " " 1943	... ...	£5,344
" " " " 1944	... ...	£5,747
" " " " 1945	... ...	£2,416

15. On 15th August, 1942, the Commissioners of Inland Revenue issued to the secretary of the Estates Company a notice that under Section 32 of the Finance Act, 1940, they had decided that in computing for the purposes of Excess Profits Tax the profits of that Company's trade or business for the accounting period ended 31st March, 1941, no deduction should be allowed in respect of Mr. Young's remuneration in excess of £3,500, being the amount which the Commissioners considered reasonable and necessary, having regard to the requirements of the trade or business and to the actual services rendered by Mr. Young. A copy of this decision it hereto annexed, marked " B ", and forms part of this Case(1).

16. On 18th December, 1942, the solicitors to the Parent Company and the Estates Company gave notice of appeal to the Board of Referees against this decision. A copy of this notice of appeal is hereto annexed, marked " C ", and forms part of this Case(1).

17. Section 34(1) of the Finance Act, 1941, provides: " If, in com-" puting the profits or loss of a trade or business for any accounting period " beginning after the end of March, nineteen hundred and forty-one, any " expenses for directors' fees or other payments for services are disallowed " under section thirty-two of the Finance Act, 1940, then, subject to the " provisions of this section, any person who pays or bears any additional " tax as a consequence of that disallowance shall be entitled to recover " from the persons to whom the fees or payments were payable the full " amount disallowed in relation to them respectively " (subject to a proviso).

Sub-section (2), in effect, makes it a condition of this right of recovery that the person liable for the tax shall give notice, both to the Inspector of Taxes and to the person to whom the disallowed fees or payments were payable, that the right of recovery is reserved against that person; and that person is himself given a right of appeal to the Board of Referees against the decision of the Commissioners to make the disallowance.

This Section does not apply to the chargeable accounting period ended 31st March, 1941, which was the period to which the appeal to the Board of Referees related, but its materiality for the purpose of the present appeal appears from the following paragraph.

18. Evidence (which we accepted) was given before us by Mr. Fermian Le Neve Foster, a partner in the firm of Messrs. Warren, Murton, Foster & Swan (the solicitors to the Parent Company and the Estates Company), who is also a director of both these Companies and of several other well-known public companies.

The witness gave evidence of the facts found by us in paragraphs 3 to 16 above, and also as follows.

When the decision of the Commissioners disallowing Mr. Young's remuneration for the year ended 31st March, 1941, in excess of £3,500 was received, he and his fellow directors knew that the Estates Company would have no right of recovery against Mr. Young for that particular year, but they also knew that if any part of his remuneration was dis-

(1) Not included in the present print.

allowed for the next or any subsequent year they would have this right of recovery.

The directors were considerably exercised about the matter and discussed it at several board meetings. Their view was that if the decision of the Commissioners of Inland Revenue was upheld as regards the year to 31st March, 1941 (as to which there was no right of recovery), it would be almost impossible to resist the disallowance of an amount in excess of £3,500 for the next and subsequent years for which the right of recovery was given.

They also took the view that, if for the next or any subsequent year a substantial amount of Mr. Young's remuneration was disallowed, the Parent Company, being a public company, would or might be bound, in justice to its shareholders, to exercise its right of recovery against Mr. Young. Foreseeing probable trouble with him, the directors considered it politic to test his reactions to the matter generally. Accordingly, on 23rd February, 1943, the directors passed the following resolution:—

"It was resolved that Mr. Foster (Messrs. Warren, Murton, Foster & "Swan—Solicitors) should make it clear to Mr. Young that if it is the "decision of the Board of Referees that any part of his remuneration "should be disallowed for purposes of E.P.T., the Company will be bound "to exercise any rights which it has against him to reclaim and recover "the amount so disallowed."

The witness personally approached Mr. Young and had several conversations with him. In the first place he sounded Mr. Young as to whether he would be prepared to agree to a compromise. Mr. Young took independent advice and decided that he would have nothing to do with an appeal (though he later modified this attitude and gave a proof of evidence in support of the Company's appeal). His attitude was that it would be a breach of faith on the part of the Company if it attempted to recover any disallowed remuneration from him.

Mr. Young had been disgruntled for four years because he did not get the full fruits of his original agreement as the result, amongst other things, of the rise in the price of potatoes. He was a servant of the Company and neither a director nor a "friend of the directors." He made it clear that he would expect to be paid the full amount of his remuneration under his agreement.

If after 1941 there was any disallowance of his remuneration and the Company attempted to recover it, the directors had reason to fear that Mr. Young (who was described by the witness as "a difficult man") would either have resigned altogether, or would have lost his enthusiasm (on which the success of the business depended), withdrawn his co-operation and "lain back and done little", in either of which events the Company would have suffered.

If all that was involved had been the tax for the year to 31st March, 1941, the Company might have compromised with the Inland Revenue (assuming the Inland Revenue had been prepared to compromise) instead of appealing to the Board of Referees. But the directors regarded the decision of the Inland Revenue as being a challenge to the commercial judgment of the Estates Company in giving Mr. Young the terms it had given him, and they considered it vital to contest the matter before the Board of Referees, otherwise the Company's future position might have been seriously prejudiced by the loss of Mr. Young's goodwill and co-

operation if the Company exercised its right to recover the amounts disallowed in subsequent years.

19. The two Companies prosecuted their appeal, which was duly heard and determined by the Board of Referees on 27th May, 1943. In addition to the "Statement of Facts and Grounds" hereinbefore referred to, prints of proofs of evidence of (*a*) Mr. F. Le Neve Foster, and (*b*) Mr. Young, furnished to the Board of Referees, are annexed hereto, marked "D" and "E", respectively, and form part of this Case(1). In accordance with the rules of procedure of the Board of Referees, all three of these documents had been previously submitted to the Inland Revenue, who had admitted the same.

The Board of Referees held that £5,800 out of the £6,486 was allowable. A copy of their determination is hereto annexed, marked "F", and forms part of this Case(1).

20. In view of this decision (which related to the year ended 31st March, 1941) the Commissioners of Inland Revenue did not seek to disallow any part of Mr. Young's remuneration for subsequent years, and his remuneration of £6,198, £5,344, £5,747 and £2,416 for the years ended 31st March, 1942, to 31st March, 1945, respectively, was allowed in full.

21. The costs incurred by the Estates Company in prosecuting the appeal were £622 10*s.* 11*d.*, consisting of the fees of Counsel, solicitors and accountants, for the preparation of, and attendance at, the proceedings before the Board of Referees, and were paid by it in the year ended 31st March, 1944.

A copy of the balance sheet and accounts of the Estate Company for that year is hereto annexed, marked "G", and forms part of this Case(1).

22. It was contended on behalf of the Estates Company that:—

(*a*) the case of *Allen* v. *Farquharson Brothers and Co.*, 17 T.C. 59, was distinguishable in that (i) the appeal before the Board of Referees related not to Income Tax but to Excess Profits Tax, and (ii) in the present case the expenditure in question was laid out for the purpose of earning profits in the strict sense of the term;

(*b*) further or alternately, that the case of *Allen* v. *Farquharson Brothers and Co.*, was wrongly decided and ought not to be followed;

(*c*) the said costs were either money wholly and exclusively laid out or expended for the purposes of the trade within Rule 3(*a*) of Cases I and II of Schedule D, or were a loss connected with or arising out of the trade within the meaning of Rule 3(*e*);

(*d*) the said costs were an admissible deduction in computing the Estates Company's profits for assessment to Income Tax, and the appeal should be allowed.

23. It was contended by the Respondent that:—

(*a*) the case was indistinguishable in principle from *Allen* v. *Farquharson Brothers and Co.*, which was applicable to Excess Profits Tax as well as to Income Tax, and the Company's motive in prosecuting the appeal was irrelevant;

(1) Not included in the present print.

(*b*) the said costs were not an admissible deduction in computing the Estates Company's profits to assessment to Income Tax, and the appeal should be dismissed.

The cases of *Strong and Company of Romsey, Ltd.* v. *Woodifield*, 5 T.C. 215; *Commissioners of Inland Revenue* v. *Alexander von Glehn & Co., Ltd.*, 12 T.C. 232; *Spofforth and Prince* v. *Golder*, 26 T.C. 310, and *L.C., Ltd.* (*in liquidation*) v. *G. B. Ollivant, Ltd. and Others*, [1944] 1 All E.R. 510, were also referred to.

24. We, the Commissioners who heard the appeal, gave our decision in writing on 12th July, 1945, in the following terms:—

1. Having regard to the observations of the Master of the Rolls, and of Viscount Simon, L.C., Lord Macmillan and Lord Wright, as to the general nature of Excess Profits Tax, in *L.C., Ltd.* (*in liquidation*) v. *G. B. Ollivant, Ltd. and Others*, [1942] 2 All E.R. 528, at page 532, and [1944] 1 All E.R. 510, at pages 514, 517 and 519-20, respectively, we do not think that the present case is distinguishable in principle from *Allen* v. *Farquharson Brothers and Co.*, 17 T.C. 59, merely because the appeal in question was against a decision of the Commissioners of Inland Revenue in relation to Excess Profits Tax and was not against an assessment to Income Tax.

2. The present case differs, however, in that (1) although the appeal itself had reference only to the taxation of excess profits already earned, it had, or might have, a direct bearing on the taxation of subsequent excess profits, and (2) by reason of this there was, in the exceptional circumstances, a special "business" motive for prosecuting the appeal, namely (in effect) the protection of the benefit of Mr. Young's services to the Company, a matter going to the earning, as distinct from the taxation, of future profits (cf. *inter alia, Commissioners of Inland Revenue* v. *Williams's Executors*, 26 T.C. 23, per the Master of the Rolls at pages 34, 35 and 37).

3. Nevertheless, the immediate purpose of the appeal was that of all taxation appeals, namely, to get a reduction of tax, or, in other words, to retain a larger share of the profits. We regard this as a substantive purpose in itself, and not as something merely incidental to the earning of future profits.

   We therefore hold that the costs of the appeal to the Board of Referees were not money "wholly and exclusively" laid out or expended for the purposes of the trade within Rule 3(*a*) of Cases I and II, and were not a "loss" within Rule 3(*e*).

   Accordingly we dismiss the appeal in principle and leave the figures of the assessment to be agreed between the parties.

25. The parties having subsequently agreed the figures, we increased the assessment to the sum of £50,063, less wear and tear £1,630, and determined the appeal accordingly.

26. The Appellant Company immediately after the determination of the appeal declared to us its 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.

F. N. D. PRESTON, } Commissioners for the Special Purposes
G. R. HAMILTON, } of the Income Tax Acts.

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

22nd January, 1946.

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(2) *Smith's Potato Crisps* (1929), *Ltd.* v. *Commissioners of Inland Revenue*

CASE

Stated under the Finance (No. 2) Act, 1939, Section 21(2), and 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 22nd June, 1945, Smith's Potato Crisps (1929), Ltd. appealed against an assessment to Excess Profits Tax made on it in respect of the profits of a subsidiary company, namely, Smith's Potato Estates, Ltd., in the estimated sum of £8,500 for the chargeable accounting period ended 31st March, 1944.

2. The sole question at issue is whether a sum of £622 10*s.* 11*d.* for legal and accountancy costs incurred in connection with an appeal to the Board of Referees under Section 32 of the Finance Act, 1940, is an admissible deduction in computing the profits of Smith's Potato Estates, Ltd. for assessment to Excess Profits Tax for the said chargeable accounting period.

3. The facts and the contentions of the parties are as set out in paragraphs 3 to 23 of the Case which we have this day stated in *Smith's Potato Estates, Ltd.* v. *Bolland* (*H.M. Inspector of Taxes*), to which we would refer.

4. Section 14(1) of the Finance (No. 2) Act, 1939, which relates to Excess Profits Tax, provides that the profits arising from a trade or business in any chargeable accounting period shall be computed on Income Tax principles as adapted in accordance with the provisions of Part I of the Seventh Schedule to that Act.

5. For the reasons set out in paragraph 24 of that Case we dismissed the appeal in principle and left the figures of the assessment to be agreed between the parties.

6. The parties having subsequently agreed that no excess profits arose in the said chargeable accounting period, we discharged the assessment.

7. The Appellant Company immediately after the determination of the appeal declared to us its 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 Finance (No. 2) Act, 1939,

Section 21(2), and the Income Tax Act, 1918, Section 149, which Case we have stated and do sign accordingly.

F. N. D. PRESTON, } Commissioners for the Special Purposes
G. R. HAMILTON, } of the Income Tax Acts.

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

22nd January, 1946.

The cases came before Atkinson, J., in the King's Bench Division on 21st and 22nd May, 1946, when judgment was reserved. On 6th June, 1946, judgment was given against the Crown, with costs.

Mr. Frederick Grant, K.C., and Mr. Geoffrey Tribe appeared as Counsel for the Companies, and the Solicitor-General (Sir Frank Soskice, K.C.) and Mr. Reginald P. Hills for the Crown.

JUDGMENT

Atkinson, J.—This is an appeal on the same lines as the case I have just dealt with[1]. There are two appeals, the first by Smith's Potato Estates, Ltd., and the second by Smith's Potato Crisps (1929), Ltd. The same questions with which I have just dealt arise, but there is also one further point with which I want to deal as shortly as I can.

Probably everybody has heard of Smith's Potato Crisps (1929), Ltd. They were very anxious to secure their own supply of potatoes for the purposes of their business. In order to do that they bought, in I think about 1936, a very big farm in Lincolnshire called the Nocton estate. I gather from the Case that it was quite a famous farm and managed by a famous farmer, a Mr. Young. They did not take the working of this farm over themselves, but they formed a subsidiary company, Smith's Potato Estates, Ltd., in order to undertake the purchase of it. The parent company held all the shares in the Estates Company, which was, therefore, a subsidiary of the parent company. They purchased the estate in April, 1936, and paid a quarter of a million pounds for it in cash, the parent company finding the money. Mr. Young had been the manager of this estate for many years. The parent company knew nothing at all about farming, but were very anxious to retain the services of Mr. Young. They entered into an agreement with him by which he received certain remuneration, including a share of profits which was expected to be substantial. But, up to the year 1940, the anticipated profits were not realised. The firm's profits were barely sufficient to pay the debenture interest and overhead charges, and Mr. Young earned no commission under the agreement. There was no suggestion that he was in any way responsible for that, but the general conditions prevailing produced that result.

So the Company had a thoroughly dissatisfied manager, whom they might lose when his agreement came to an end. As a result of that a new agreement had to be negotiated. Negotiations were concluded on or about 1st April, 1941, and a new agreement was made to take effect as from

(1) Rushden Heel Co., Ltd. *v.* Keene and Rushden Heel Co., Ltd. *v.* Commissioners of Inland Revenue, page 298 *post*.

(Atkinson, J.)

6th April. There were a number of variations of the old agreement, and the result of it was that in the accounting year which ended 31st March, 1941, he made an income of £6,486, which expenditure was included in the accounts of the Estates Company. For the year 1942 he made again over £6,000, in 1943 over £5,000, in 1944 £5,700 odd, and so on.

On 15th August, 1942, the Commissioners of Inland Revenue issued to the secretary of the Estates Company a notice under Section 32 of the Finance Act, 1940, a Section relating to Excess Profits Tax. The Section is in these terms: "In computing the profits of any trade or business for any "accounting period, no deduction shall be allowed in respect of expenses "in excess of the amount which the Commissioners consider reasonable "and necessary, having regard to the requirements of the trade or business, "and, in the case of directors' fees or other payments for services, to the "actual services rendered by the person concerned." Then it is provided that any person who is dissatisfied may appeal to the Board of Referees.

Under that Section, for some reason, the Commissioners said they had decided that no deduction should be allowed in respect of Mr. Young's remuneration in excess of £3,500, the amount which the Commissioners considered "reasonable and necessary, having regard to the requirements "of the trade or business and to the actual services rendered by Mr. "Young." What they knew about the services he rendered, or the requirements of the trade or business, does not appear, but that was the view they took.

The Appellant Company were put by this in grave difficulty. The difficulty they were put in, as regards the first year, was a difficulty which, though not arising in that year, would apply to all subsequent years. It was a difficulty which arose under Section 34 of the Finance Act, 1941, which provides: "If, in computing the profits or loss of a trade or busi- "ness for any accounting period beginning after the end of March, nineteen "hundred and forty-one, any expenses for directors' fees or other payments "for services are disallowed under section thirty-two of the Finance Act, "1940, then, subject to the provisions of this section, any person who pays "or bears any additional tax as a consequence of that disallowance shall "be entitled to recover from the persons to whom the fees or payments "were payable the full amount disallowed in relation to them respectively". The directors of Smith's Potato Crisps were put in this very awkward position. Not merely were they being made to pay on this basis a sum of £2,500 or more extra in taxation, but they saw that, if they did not do something about it, they would have very little chance of getting that £3,500 raised in subsequent years. It would be taken as agreed that £3,500 was a reasonable remuneration, and they had a very good ground for taking it for granted that that would be the basis of his future allowed remuneration. Then they would be in this difficulty. If they did their duty to the shareholders, they ought to recover under that Section any excess from Mr. Young. If they did, then they would lose Mr. Young, who would certainly go at the first opportunity he had. They would be breaking their bargain with him, to pay him certain commission. So they were put in a dilemma. The Special Commissioners found that the board had considered it vital to test the matter before the Board of Referees on that ground, because otherwise the Company's future position might be seriously prejudiced by the loss of Mr. Young's goodwill and co-operation if the Company exercised its right to recover the

(Atkinson, J.)

commissions disallowed in subsequent years. So they appealed and they won, and Mr. Young's remuneration was fixed at £5,800.

The costs incurred in that matter were some £600 odd. The same question arises here as arose in the last case, namely, were they entitled to have those costs allowed in the assessment for Excess Profits Tax and in the assessment for Income Tax? The Excess Profits Tax fell upon the parent company. The subsidiary company's profits are thrown in with the main company's profits, and, therefore, the parent company are the Appellants with regard to the disallowance for the purposes of Excess Profits Tax, and the Estates Company, the subsidiary company, are the Appellants in respect of the disallowance for the purpose of calculating Income Tax. The reasons I have given in the case which I have just decided are just as applicable here, and are sufficient to lead to the allowing of these appeals.

But I was further pressed with this point. It was said there was another ground, quite apart from the one I have referred to, which ought to prevail. It was contended, even if I dismissed the appeal on the first ground, that there was a finding of the Commissioners that it was really vital for the Company to take the step of appealing for the purpose of retaining the goodwill and future services of Mr. Young, and that that was a sufficient ground for allowing this appeal. I think that is a well-founded argument. If an expense incurred for the purpose of getting rid of a director who is troublesome—I think that was the word which was used in the case—is an allowable expenditure(1), surely an expenditure for the purpose of retaining somebody who is vital to the business is an expenditure which is proper to be incurred and which is, even on a narrow interpretation of the phrase, incurred for the purpose of gaining profits. Therefore, on that ground too, I would allow the appeal, if I did not allow it on the other ground. Both appeals are allowed with costs.

Mr. Tribe.—Would your Lordship order that the appeal be remitted to the Commissioners for the necessary adjustment of figures?

Atkinson, J.—If that is the proper Order, yes.

Mr. Tribe.—If your Lordship pleases.

The Crown having appealed against the decision in the King's Bench Division, the cases came before the Court of Appeal (Lord Greene, M.R., and Morton and Somervell, L.JJ.) on 10th, 11th and 12th March, 1947, when judgment was reserved. On 2nd April, 1947, judgment was given unanimously in favour of the Crown, with costs, reversing the decision of the Court below.

The Solicitor-General (Sir Frank Soskice, K.C.) and Mr. Reginald P. Hills (Mr. Norman Rowe with them) appeared as Counsel for the Crown, and Mr. Frederick Grant, K.C., and Mr. Geoffrey Tribe for the Companies.

JUDGMENT

Lord Greene, M.R.—In these two appeals similar questions are raised to those with which I have already dealt in the two appeals of *Rushden Heel Co., Ltd.* v. *Keene* and *Rushden Heel Co., Ltd.* v. *Commissioners of*

(1) Mitchell *v.* B. W. Noble, Ltd., 11 T.C. 372.

(Lord Greene, M.R.)

Inland Revenue (1), the decision in which admittedly covers them. There is, however, an additional argument based on special facts which were not present in the *Rushden Heel* cases, and those facts I must now state sufficiently to make this judgment intelligible.

Smith's Potato Estates, Ltd. (the "Estates Company") is a subsidiary of Smith's Potato Crisps (1929), Ltd. (the "Parent Company"), and the latter Company was assessable to Excess Profits Tax in respect of the profits of the Estates Company. The Commissioners of Inland Revenue, acting under Section 32 of the Finance Act, 1940, disallowed in the computation of profits of the Estates Company for the period ending 31st March, 1941, the excess over £3,500 of the remuneration paid to Mr. Young, the general manager of the Estates Company. Both Companies appealed to the Board of Referees and were successful in getting the sum of £3,500 increased to £5,800. The Estates Company incurred legal and accountancy costs in the preparation and prosecution of that appeal and claimed to deduct them in computing its profits for Income Tax purposes. This claim of the Estates Company is the subject of the first of these two appeals. The second of the two appeals is concerned with a claim by the Parent Company (which is assessable to Excess Profits Tax, as above mentioned, in respect of the profits of the Estates Company) to deduct the same costs in computing the profits of the Estates Company for purposes of Excess Profits Tax. The Special Commissioners rejected both claims, but their decision was reversed in each case by Atkinson, J., in accordance with his judgment in the *Rushden Heel* cases. The Special Commissioners also decided the additional point in favour of the Crown, but Atkinson, J., although it was not necessary for his decision, thought that they were wrong in so doing.

The additional point arises in this way. In 1936 the Parent Company, a very large consumer of potatoes, being desirous of providing a secure source of supply, formed the Estates Company as a wholly owned subsidiary for the purpose of acquiring, as it did acquire, a well-equipped farm of 6,944 acres. As the boards of the two Companies had no knowledge of farming, Mr. Young, who had managed the farm for the vendors for many years, was engaged as manager at a fixed salary and a commission under a written agreement. Owing to a variety of circumstances this agreement did not produce for Mr. Young the level of remuneration which had been expected, and as the result of his dissatisfaction and other considerations, the boards, who attached great importance to keeping the services of Mr. Young, paid him a substantial bonus for the year ending 31st March, 1940. Mr. Young, however, still had grounds for dissatisfaction, and in September, 1940, he gave notice to terminate his engagement intimating that he would not renew it unless the terms were substantially altered. As a result of negotiations a new agreement was entered into under which Mr. Young's remuneration for the year ending 31st March, 1941, worked out at £6,486 14*s.* 0*d.* His remuneration in the preceding years had been very much smaller. It was the excess of this sum over £3,500 that the Commissioners of Inland Revenue disallowed as above-mentioned. By virtue of Section 34(1) of the Finance Act, 1941, if a similar disallowance had taken place in respect of any accounting period after the end of March, 1941, the Parent Company, by reason of the additional tax which would thereby have fallen upon it,

(1) Page 298 *post*.

(Lord Greene, M.R.)

on giving notice to Mr. Young would have been entitled to recover from him the amount of such additional tax. Although this Section did not apply to the period in respect of which the costs in dispute were incurred, it was feared that the disallowance of the excess salary which had taken place would be followed by similar disallowances in the following years, and that in that case the Parent Company would or might, as a public company, be obliged to enforce its rights against Mr. Young. Mr. Young protested vigorously against the suggestion that in future years action might be taken in this way and insisted on being paid in full. The two Companies regarded Mr. Young as essential to the well-being of the enterprise and were afraid that, if they did have occasion to enforce their rights against him, they would suffer through his discontent. They accordingly prosecuted their appeal to the Board of Referees with the success already described, and as a result the Commissioners of Inland Revenue did not seek to disallow any part of Mr. Young's remuneration in subsequent years.

The commercial advantages thus obtained were relied on as affording a special ground for saying that the costs in question were money wholly and exclusively laid out for the purposes of the trade. The Special Commissioners held that there was a special "business" motive for prosecuting the appeal to the Board of Referees, namely, the protection of the benefit of Mr. Young's services, a matter going to the earning, as distinct from the taxation, of future profits, but that the immediate purpose of the appeal was that of all taxation appeals, namely, to get a reduction of tax. This they regarded as a substantive purpose in itself and, accordingly, they thought that the costs of the appeal were not wholly and exclusively laid out for the purpose of the trade. Atkinson, J., thought that, as the expense of getting rid of a troublesome director is an allowable expenditure(1), expense incurred for the purpose of retaining an employee who is vital to the business must also be allowable.

In my opinion the Special Commissioners took the right view. It is in substance the same as the view which I have already expressed in the *Rushden Heel* cases(2), namely, that costs incurred in ascertaining the correct amount of tax are incurred by a taxpayer partly if not mainly in his capacity as a taxpayer, and for the purpose of securing that his liability as a taxpayer is assessed at the correct amount, and cannot be said to be wholly and exclusively laid out for the purposes of his trade. The analogy taken by Atkinson, J., is, I think, with all respect, a misleading one. Expense incurred in getting rid of a troublesome director is what I have described in my judgment in the *Rushden Heel* cases as a commercial expense. No element of liability as a taxpayer enters into it, and there is no question of a dual purpose, such as there is when one purpose in incurring the expense is to secure a reduction of liability to tax.

Both appeals must be allowed with costs here and below.

Morton, L.J.—I agree, and I cannot usefully add anything.

Lord Greene, M.R.—I have **Somervell, L.J.'s** authority to say he has read the judgment which I have just delivered, and he agrees with it.

Mr. Rowe.—In these cases it will be remitted to the Special Commissioners to make their directions in accordance with your Lordship's judgment?

(1) *See* Mitchell *v.* B. W. Noble, Ltd., 11 T.C. 372. (2) Page 298 *post.*

Lord Greene, M.R.—Yes.

Mr. Tribe.—Would your Lordship's leave to appeal be extended to the Appellant in this case?

Lord Greene, M.R.—What does the Crown say about this, Mr. Rowe? The cases, except for one special point, are on all fours.

Mr. Rowe.—Yes.

Lord Greene, M.R.—It does not seem desirable that the taxpayers' money should be spent in two appeals in relation to the same point.

Mr. Rowe.—Quite so.

Lord Greene, M.R.—On the other hand, there is a special point in the *Smith* cases which, of course, is not a point likely to recur, and does not raise any question of principle at all, as it seems to me.

Mr. Rowe.—No, my Lord.

Lord Greene, M.R.—Is the Crown prepared to say that they will be bound in dealing with the *Smith* cases by the decision in the *Rushden Heel* case(1) in the House of Lords?

Mr. Rowe.—If your Lordship will bear with me for one moment I will take instructions. (*Mr. Rowe conferred with his clients.*) I am instructed the Crown will be bound in these two cases.

Lord Greene, M.R.—That ought to be enough for you, Mr. Tribe.

Mr. Tribe.—With respect, might I just make a short submission on this point? Your Lordship has referred to the special point we have, and your Lordship takes the view that it is not, as is the other point, one that is likely to be of far-reaching importance. On the other hand your Lordships are differing again from the learned Judge on that particular aspect of the case. I would make a further submission in this connection to your Lordships, that for that reason alone you might see fit to allow my clients leave. Apart from that I submit these cases have been argued independently before different bodies of Commissioners, and in each Court so far. My clients have been independently and separately represented, and they would feel that the representation they have had and have paid for up to this point they should be permitted—they submit this through me to your Lordships—to continue now as far as the House of Lords.

Morton, L.J.—I suppose it does make a difference to your clients of about £2,500 a year for how many years?

Mr. Tribe.—All the way through to the end of the Excess Profits Tax.

Morton, L.J.—That is about five years.

Mr. Tribe.—It would be so.

(*The Court conferred.*)

Lord Greene, M.R.—I think, Mr. Rowe, perhaps it would be a little bit unfair to deprive these Respondents of their independent right to appeal. I was trying to think if there was some way of avoiding expense by means of a joint case, but I do not think that can be done.

Mr. Rowe.—No, my Lord. I am in your Lordships' hands.

Lord Greene, M.R.—Very well, you can have your leave, Mr. Tribe.

Mr. Tribe.—I am much obliged.

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(1) Page 298 *post.*

Appeals having been entered against the decision in the Court of Appeal, the cases came before the House of Lords (Viscount Simon and Lords Porter, Simonds, Normand and Oaksey) on 19th, 20th, 22nd and 23rd April, 1948, when judgment was reserved. On 14th July, 1948, judgment was given in favour of the Crown (Viscount Simon and Lord Oaksey dissenting), with costs, confirming the decision of the Court below.

Mr. Frederick Grant, K.C., and Mr. Geoffrey Tribe appeared as Counsel for the Companies, and the Solicitor-General (Sir Frank Soskice, K.C.) and Mr. Reginald P. Hills for the Crown.

JUDGMENT

Viscount Simon.—My Lords, I have had the advantage of studying the opinions prepared by my colleagues who sat with me in hearing the arguments in these consolidated appeals, and as these opinions are not unanimous I feel that I should briefly express my own conclusion, even though this will not affect the ultimate result. It is not necessary for me to set out the detailed facts in these two cases; they are fully stated in the opinion about to be delivered by my noble and learned friend Lord Porter.

The main question to be decided is whether the legal and accountancy expenses of prosecuting an appeal (in this instance, a successful appeal) to the Board of Referees against a decision of the Commissioners of Inland Revenue under Section 32 of the Finance Act, 1940, incurred by a taxpayer with a view to reducing the assessment made upon him as a trader for Excess Profits Tax, can be deducted as being a disbursement " wholly and exclusively laid out or expended for the purposes " of the trade " (Rule 3(*a*) of the Rules applicable to Cases I and II of Schedule D). The Commissioners had fixed the proper figure for an item of disbursement at £3,500; the result of prosecuting the appeal, at a cost of £622 10*s*. 11*d*., was to establish that the proper figure was £5,800.

Atkinson, J., held that the expense of £622 10*s*. 11*d*. was an admissible deduction on the ground that the cost of the litigation was incurred for the purpose of ascertaining the true figure of profits on which the trader must bear Excess Profits Tax. The Court of Appeal (Lord Greene, M.R., and Morton and Somervell, L.JJ.) reversed this decision, holding that the disbursement was not " wholly and exclusively " incurred for the purposes of the trade, but was at any rate in part incurred in an endeavour to reduce the amount of tax which the taxpayer had to pay.

It is to be observed that the size of the figure to be deducted, £5,800 instead of £3,500, not only affects the correct calculation of Excess Profits Tax for the year, but also the adjustment later on of the total burden of such tax to be borne by the trader. Moreover, since Excess Profits Tax is deductible as an expense when calculating the proper assessment of the trader to Income Tax, the fixing of a correct figure for the former is essential to the correct calculation of the latter. And is is only when the latter is ascertained that the trader knows how much of his commercial profit he can carry forward, or, if a company, how much of the year's profit is available for dividend or for reserve.

It seems to me that it is essential for the proper carrying on of a trade that the trader should know what portion of his profits in a

(Viscount Simon.)

given year is left to him after the Revenue has taken its share by taxation. If, therefore, he considers that the Revenue seeks to take too large a share and to leave him with too little, the expenditure which the trader incurs in endeavouring to correct this mistake is a disbursement laid out for the purposes of his trade. If he succeeds he will have more money with which to earn profits next year. It is true that the *result* of his success is to reduce the tax he has to pay—alternatively, one may say that the result is to show that the profit of the year's trading left to him after paying tax is greater than the Revenue was willing to admit—but to my mind the *purpose* was a trading purpose and nothing else. The trade is not to be regarded as extending over twelve months and no more; indeed, as I have already pointed out, Excess Profits Tax is liable to be adjusted in the light of subsequent trading results, and assessment for Income Tax is arrived at on figures of the previous year.

With all respect to those who think otherwise, I regard it as fallacious to argue that the trader's expenditure in fighting the Revenue's assessment is not "wholly and exclusively" incurred for the purposes of the trade, because the expenditure would not be incurred if there was no tax to pay. If there was no tax to pay, the benefit realised by the trader from carrying on the trade would not be reduced by taxation, and it is the purpose of trade (at any rate under private enterprise) to make its legitimate profit.

Viewed in this light I do not see why the expenditure here in question is not wholly and exclusively laid out for the purposes of the trade; if it had not been incurred, the trade would be less profitable. Lord Davey's gloss on the words of the statute in ***Strong and Company of Romsey, Ltd.*** v. ***Woodifield***, [1906] A.C. 488 (5 T.C. 215), is well known, but I think it is better to concentrate on the statutory words themselves. Rightly understood, however, I do not find that Lord Davey's words contradict the view that I am disposed to take. ***Strong and Co.*** v. ***Woodifield*** was a case in which the taxpayer sought to deduct a loss not connected with or arising out of his trade. Lord Loreburn, L.C., said, at page 452 (5 T.C., at page 219): "I think only such losses can be deducted as are connected with, "in the sense that they are really incidental to, the trade itself." Lord Davey's test was that the purpose of the expenditure must be "the pur- "pose of enabling a person to carry on and earn profits in the trade" (page 453; 5 T.C., at page 220). Here the expenditure was, in my view, incurred for the purpose of carrying on and earning profits in the trade, for a reduction in the amount of tax does increase the fund in the trader's hands after tax is paid and so promotes the carrying on of the trade and the earning of trading profits. The incidental consequence that the trader is not taxed so heavily in respect of his profits from trade does not, as it seems to me, alter the fact that the litigation was wholly and exclusively undertaken for the purposes of the trade. My own opinion, therefore, would be that the appeal should be allowed, but in view of the opinion of the majority of your Lordships I move that it be dismissed with costs.

Lord Porter.—My Lords, these consolidated appeals raise the question whether in computing their profits for Income Tax purposes in respect of the year ending 31st March, 1944, the Appellants in the first appeal are entitled to deduct a sum of £622 10*s.* 11*d.*, being the legal and accountancy

(Lord Porter.)

expenses incurred in prosecuting an appeal to the Board of Referees against a decision of the Commissioners of Inland Revenue given under Section 32 of the Finance Act, 1940.

These Appellants are a wholly-owned subsidiary of the Appellants in the second appeal and the matter for decision in that case is whether the same sum is deductible in computing the profits of the first Appellants for the purpose of assessment to Excess Profits Tax for the chargeable accounting period ending on the same date. Under the provisions of Paragraph 2 of Part I of the Fifth Schedule to the Finance Act, 1940, assessments to Excess Profits Tax in respect of the profits of the first Appellants fall to be made on the second Appellants, but with a provision under Paragraph 8 of Part IV of that Schedule for the reimbursement by the first Appellants of the second Appellants if they pay the tax.

The first Appellants were formed to purchase and manage an estate at Nocton in Lincolnshire, on which it was hoped to grow a supply of potatoes sufficient for the requirements of the second Appellants. That estate, before its purchase, had been managed by a Mr. Young, and in order to ensure its successful working it was thought essential to continue to employ him for that purpose. After four years' service Mr. Young was dissatisfied with the terms of his remuneration, and on 4th March, 1941, a new agreement was entered into between him and the first Appellants for a term of six years certain from 6th April, 1940, and thereafter until determined by six months' notice on either side.

Under this agreement he received an increased remuneration, amounting in 1940 to £3,550, in 1941 to £6,486, in 1942 to £6,198, in 1943 to £5,334, in 1944 to £5,747 and in 1945 to £2,416. On 15th August, 1942, the Commissioners of Inland Revenue issued to the secretary of the first Appellants a notice stating that under Section 32 of the Finance Act, 1940, they had decided that in computing for the purposes of Excess Profits Tax the profits of that Company's trade or business for the accounting period ending 31st March, 1941, no deduction should be allowed in respect of Mr. Young's remuneration in excess of £3,500. From this decision both companies appealed to the Board of Referees and that body held that £5,800 was allowable. From and after that period the Inland Revenue authorities have not challenged the allowance of the full amount actually paid, and the sum now in dispute represents the costs incurred in prosecuting this appeal.

Under Schedule D, tax is charged in respect of the annual profits or gains arising or accruing to any person residing in the United Kingdom, and the relevant statutory provisions as to the deductions to be allowed are to be found in Rule 3(*a*) of the Rules applicable to Cases I and II of Schedule D, and read as follows:

" 3. In computing the amount of the profits or gains to be charged, " no sum shall be deducted in respect of —

" (*a*) any disbursements or expenses, not being money wholly " and exclusively laid out or expended for the purposes of " the trade, profession, employment, or vocation."

Excess Profits Tax is dealt with in Section 14(1) of the Finance (No. 2) Act, 1939, which enacts that for the purpose of that tax, the profits arising from a trade or business should be computed on Income Tax

(Lord Porter.)

principles as adapted in accordance with the provisions of Part I of the Seventh Schedule to the Act, and defines Income Tax principles in relation to a trade or business as the principles upon which the profits arising from the trade or business are computed for the purpose of Income Tax under Case I of Schedule D or would be so computed if Income Tax were chargeable under that Case in respect of the profits so arising.

The only other provision of this Act which need be quoted is that contained in Section 18(1), namely: "The amount of the excess profits tax "payable in respect of a trade or business for any chargeable accounting "period shall, in computing for the purposes of income tax the profits and "gains arising from that trade or business, be allowed to be deducted as an "expense incurred in that period."

The Appellants relied upon this last Section coupled with the fact that Excess Profits Tax is imposed on traders only, and urged that the expense of ascertaining the sum properly deductible as Excess Profits Tax from Income Tax was an expense wholly and exclusively laid out for the purposes of the trade.

A subsidiary question arises as to whether the expenditure incurred, in order to ascertain the sum properly allowable, was undertaken to save tax or for the purposes of retaining the services of Mr. Young, but from the facts already stated it is plain that the main question in the case is concerned with the true meaning of the expression "wholly and exclusively "laid out for the purposes of the trade", and more particularly with the phrase "purposes of the trade".

The phraseology and its meaning have been dealt with in a considerable number of cases, but before considering their effect I think it desirable to state the conclusion at which I should have arrived from a study of the wording of the Section itself.

The widest meaning attributed to it, and that for which the Appellants contend, is perhaps best expressed by saying that it includes every expense to which the trader is put because he carries on the trade. Were he not a trader, it is contended, he would not have to pay Excess Profits Tax, and therefore any expense to which he is put in arriving at its correct figure is wholly and exclusively laid out for the purposes of the trade. Similarly, it is maintained that, as the law obliges him to pay Income Tax, his expenses of calculating the balance of profits and gains for Income Tax purposes are incurred wholly and exclusively for the purpose of his trade, more particularly where the taxpayer is a company which by law is compelled to publish its accounts. In support of this argument it is urged that even the amount available to be put aside as reserve or for distribution in dividends cannot be ascertained until it is known what sum must be provided for Excess Profits Tax and Income Tax purposes.

The argument, so far, extends only to expenditure incurred for the purpose of finding out what the balance of profits or gains is, but, it is said, if the cost of ascertaining that balance by making up the Company's accounts is wholly and exclusively laid out for the purposes of its trade, so the expense of ensuring by an appeal to the Board of Referees the correctness of the figure reached is equally wholly and exclusively laid out for that purpose.

The opposite view, maintained by the Crown, is perhaps best expressed in the case of *Strong and Company of Romsey, Ltd.* v. *Woodifield,* [1906]

(Lord Porter.)

A.C. 448, at page 453 (5 T.C. 215, at page 220), where Lord Davey says: "These words . . . appear to me to mean for the purpose of enabling a "person to carry on and earn profits in the trade".

My Lords, that expression has often been referred to and approved, but it was used in reference to the circumstances of the case then under consideration, and I doubt if it carries the matter to a final conclusion. It still leaves open the question: What expense is incurred for the purpose of enabling a trader to earn profits? and the adoption of a phrase helpful in analysing the meaning of words in an Act of Parliament with reference to a particular set of circumstances is not necessarily either useful or conclusive in all cases. It is probably safer to retain the wording of the Act itself and, by applying it to the facts established, to discover whether the deduction falls within its terms or not.

Regarding the circumstances which your Lordships have to consider from this point of view, I should myself draw a marked distinction between accounts made up on the purely trading basis and those which are prepared for and accepted by the Inland Revenue. If there were no obligation to ascertain and pay either of these taxes, there would be no necessity for making up accounts on Income Tax principles, it would suffice to make up the ordinary commercial accounts. The computation of accounts for tax purposes is therefore not directly associated with the carrying on of the business. It is an obligation imposed upon the Company for another and extraneous purpose, that is, for the purpose of ascertaining the tax to be paid out of profits. It is not, at any rate directly, undertaken for trade purposes but to satisfy the Revenue authorities.

It is true that as a matter of convenience the cost of making up accounts for the Inland Revenue is allowed by the authorities as a deduction from profits, as is the cost of making up the strictly business accounts of the trade, but this is not a matter of principle but of expediency. The two duties overlap and in practice are almost indivisible. Moreover it is of advantage to the Revenue to have the figures required for their purposes carefully and accurately made up. Strictly, however, I think the expenses should be divided, and any additional cost of making up Revenue accounts should be disallowed in determining the allowable deduction for Income Tax purposes, but the advantages of allowing both to be deducted as a practical measure outweigh the disadvantages, though the result may not be strictly logical. But no such illogicality has to be faced when the sum which is alleged to be deductible is not the cost of accountant's work in ascertaining trading profits, but the expense of an appeal to the Board of Referees for the purpose of discovering the true measure of profits for tax purposes only. Such expenditure is incurred directly for tax purposes and for nothing else, though it may indirectly affect both the amount available for distribution to the proprietors of the business and that proper to be put to reserve.

This is the conclusion which I should have reached if left to determine the question unassisted and unembarrassed by authority. It remains to be determined whether your Lordships' decisions in previous cases throw doubt upon this view.

My Lords, the case of *Strong* v. *Woodifield* may be said to form the starting point for deducing the principles at stake in the present appeal

(Lord Porter.)

and, though the words of Lord Davey quoted above are the expression most frequently referred to, I think that those of Lord Loreburn, L.C., have equal, if not greater, importance. He says, [1906] A.C., at page 452(1): "It does not follow that if a loss is in any sense connected with the trade, "it must always be allowed as a deduction; for it may be only remotely "connected with the trade, or it may be connected with something else "quite as much as or even more than with the trade. I think only such "losses can be deducted as are connected with, in the sense that they are "really incidental to, the trade itself. They cannot be deducted if they are "mainly incidental to some other vocation or fall on the trader in some "character other than that of trader." Further, Lord Davey, after pointing out that Case I relates to trades, manufactures, adventures, or concerns in the nature of trade, goes on to say, at page 453(2): "It is not enough "that the disbursement is made in the course of, or arises out of, or is "connected with, the trade, or is made out of the profits of the trade. It "must be made for the purpose of earning the profits."

These expressions of opinion, given some forty years ago and accepted ever since, are, in my view, inconsistent with the Appellants' contention but it is said they are at best dicta and are inconsistent with the principles upon which such authorities as *Smith* v. *Lion Brewery Co., Ltd.,* [1911] A.C. 150 (5 T.C. 568), and *Usher's Wiltshire Brewery, Ltd.* v. *Bruce,* [1915] A.C. 433 (6 T.C. 399), are based, and in particular with the observations of Viscount Cave, L.C., in *British Insulated and Helsby Cables, Ltd.* v. *Atherton,* [1926] A.C. 205 (10 T.C. 155), who says that it has often been pointed out that the Act does not contain any express allowance or enumeration of deductions, and therefore it is necessary first to enquire whether the deduction is expressly prohibited and if not whether it is of such a nature as to be proper to be charged against incomings in a computation of the balance of profits and gains. He goes on to state, at page 212(3), that: "A sum "of money expended, not of necessity and with a view to a direct and "immediate benefit to the trade, but voluntarily and on the grounds of "commercial expediency, and in order indirectly to facilitate the carrying "on of the business, may yet be expended wholly and exclusively for the "purposes of the trade."

My Lords, this statement was *obiter* only, as the actual decision was merely that the expenditure was capital expenditure and, therefore, not deductible, but the language does require careful consideration. In that case the question actually in issue was whether subscriptions by a company towards a pension fund were to be deducted in ascertaining the balance of profits and gains of its trade, and it is true that the expenditure did not at once affect its revenue, but it was a method of ensuring the better and more contended service of its employees and in that sense it did directly affect the success of its enterprise. It was exclusively laid out to enable the company to be more successful; no part of it was incurred in order to ascertain the Revenue's proportion of the profits when made.

So far as Income Tax is concerned there is direct authority in the High Court in *Allen* v. *Farquharson Bros. and Co.,* 17 T.C. 59, that the cost of opposing the Inland Revenue in a contest as to what the profits of a business are, is not deductible. But it is said that case merely followed

(1) 5 T.C., at p. 219. (2) *Ibid.,* at p. 220. (3) 10 T.C., at p. 191.

(Lord Porter.)

Strong v. *Woodifield*(1), and in any case Excess Profits Tax differs inasmuch as it is imposed on a trader only and therefore the cost of ascertaining it is part of the trade. I do not accept this contention. It is true that a trader only is liable to pay it, but it is not payable by him as a trader. He pays as an individual, like any other individual, tax on the sum which he has earned as a trader.

"To my mind", said Lord Selborne, L.C., in *Mersey Docks and Harbour Board v. Lucas* (1883), 8 App. Cas. 891, at page 905 (2 T.C. 25, at page 29), "it is reasonably plain that the gains of a trade are that which "is gained by the trading, for whatever purposes it is used", and therefore what your Lordships have to determine is whether the expense is incurred in order to earn gain, or is the application or distribution of that gain when earned. With all respect to the opposing view, expenditure to ascertain the true amount of tax to be paid, whether it be Income Tax or Excess Profits Tax, and whether successful or unsuccessful, is, in my opinion, incurred, at any rate in part, in order to determine the correct amount of Income Tax or Excess Profits Tax, as the case may be, and not in order to earn gain, even though that phrase be given a broad significance. The same conclusion might be reached by saying, in the words of this statute, that such expense is not wholly or exclusively laid out for the purposes of trade. It is in truth partially, if not wholly, laid out in order to discover what sum is to be paid to the Crown out of the profits or gains, which have already been earned and computed.

In these two consolidated appeals the further point was argued that those appeals were launched and consequent expense incurred in order that Mr. Young's services might be retained. The Special Commissioners, however, have found that one main object, though possibly not the most prominent, was to save tax. They had evidence on which they could so find and in these circumstances this is not a matter in which your Lordships would interfere.

I should dismiss both appeals.

Lord Simonds (read by Lord Normand).—My Lords, these consolidated appeals, the one by *Smith's Potato Estates, Ltd.*, which I will call "the "Estates Company", and the other by *Smith's Potato Crisps* (1929), *Ltd.*, which I will call "the Parent Company", since the Estates Company is its subsidiary, raise questions of Income Tax and Excess Profits Tax upon which Atkinson, J., and the Court of Appeal have come to different conclusions.

In the Income Tax appeal the question is whether certain expenses, amounting to £622 10*s.* 11*d.*, incurred by the Estates Company in promoting an appeal to the Board of Referees under a statutory provision in respect of liability to Excess Profits Tax ought to be deducted in computing the profits of the business of the Company for purposes of Income Tax under Case I of Schedule D of the Income Tax Act, 1918. In the Excess Profits Tax appeal the question is whether the same expenses ought to be deducted in computing the profits of that business for purposes of Excess Profits Tax under Part III of the Finance (No. 2) Act, 1939, and enactments amending that Part. The Parent Company are Appellants in the Excess Profits Tax appeal because they are chargeable to that tax in respect of the profits of the business of the subsidiary company.

(1) 5 T.C. 215.

(Lord Simonds.)

The appeal to the Board of Referees, the expenses of which have given rise to these questions, was an appeal by the Estates Company against the disallowance by the Commissioners of Inland Revenue under Section 32 of the Finance Act, 1940, of the deduction of certain fees and payments for services to a manager of the business of the Estates Company in computing the profits of its trade or business for the purposes of Excess Profits Tax. The appeal was allowed by the Board of Referees. It is not disputed that the expenses were reasonable and properly incurred.

It is necessary to refer to only a few statutory provisions. It is provided by Section 14(1) of the Finance (No. 2) Act, 1939, that for the purposes of Excess Profits Tax the profits arising from a trade or business shall be computed on Income Tax principles, subject to certain adaptations which are not relevant to the present case, and it is further provided that: "For the purposes of this subsection, the expression 'income tax principles' "in relation to a trade or business means the principles on which the "profits arising from the trade or business are computed for the purposes "of income tax under Case I of Schedule D, or would be so computed if "income tax were chargeable under that Case in respect of the profits so "arising." Section 18(1) of the same Act provides that: "The amount "of the excess profits tax payable in respect of a trade or business for any "chargeable accounting period shall, in computing for the purposes of in-"come tax the profits and gains arising from that trade or business, be "allowed to be deducted as an expense incurred in that period". As will appear, the Estates Company relied upon this Section in the Income Tax appeal.

The first Section that I cited refers me back to Case I of Schedule D, under which Income Tax is imposed upon the profits of any trade, manufacture, adventure or concern in the nature of a trade, and the profits are directed to be computed in accordance with the Rules applicable to the sources comprised in that Case. By Rule 3 (*a*) of the Rules applicable to Cases I and II it is provided as follows:

> "3. In computing the amount of the profits or gains to be "charged, no sum shall be deducted in respect of—(*a*) any disburse-"ments or expenses, not being money wholly and exclusively laid out "or expended for the purposes of the trade, profession, employment, "or vocation".

These are the words round which the main argument has ranged. It has been contended as a general proposition that the expenses of disputing an assessment to Income Tax and litigating it to the utmost permissible extent are deductible for the purpose of computing the amount of profits of the trade to be charged. But a subsidiary argument also was developed upon the facts of the particular case on which I must say a few explanatory words.

The manager of the Estates Company, whose remuneration had been the subject of the disallowance by the Commissioners of Inland Revenue and of the appeal to the Board of Referees, was a Mr. Young. His services were regarded as of great importance by the Estates Company, who feared that they might be lost, if in the year under review and in future years any part of his remuneration should be disallowed. It was therefore contended that there was in the exceptional circumstances of the

(Lord Simonds.)

case a special business motive for incurring the expenses of an appeal, a matter which went to the earning of future, as distinct from the taxation of past, profits.

Both on the general and the subsidiary contentions the Special Commissioners were against the Appellants. As I read their decision they accepted that there was the "special business motive" that I have stated, but added these words: "Nevertheless, the immediate purpose of the "appeal was that of all taxation appeals, namely, to get a reduction of tax, "or, in other words, to retain a larger share of the profits. We regard "this as a substantive purpose in itself, and not as something merely inci-"dental to the earning of future profits." They therefore held that the expenses in question were not money "wholly and exclusively" laid out or expended for the purposes of the trade within Rule 3(*a*) of Cases I and II. They added that they were not a "loss" within Rule 3(*e*), but that is not a matter which has now to be considered.

Atkinson, J., took a different view. He thought that an expense properly and reasonably incurred in the final ascertainment of profits could be considered an outlay in order to earn profits. And apart from this general ground he thought that in the particular circumstances of the case the expenses might be deducted upon the footing that expenditure for the purpose of retaining somebody really vital to the business was expenditure which was "even on a narrow interpretation of the phrase, incurred for "the purpose of gaining profits".[1]

The Court of Appeal unanimously reversed the judgment of Atkinson, J., on both points, and in spite of the able and cogent arguments of Counsel for the Appellants I cannot entertain any doubt that the decision of the Court of Appeal is right.

My Lords, I suppose that few expressions have been discussed more often in the Court than that which you have once again to consider, "money wholly and exclusively laid out or expended for the purposes of the "trade". But it is their application rather than their meaning that is in doubt. I agree with the submission of learned Counsel, that it does not help to substitute other words for those which are found in the statute and then to put a gloss upon those other words. But it is, I think, important to emphasise that the words "for the purposes of the trade" in their context, that is, where a computation of profits for the ascertainment of taxable income is being made, must mean "for the purpose of enabling a person to "carry on and earn profits in the trade". These familiar words I cite from Lord Davey's speech in *Strong and Company of Romsey, Ltd.* v. *Woodifield*, [1906] A.C. 448, at page 453 (5 T.C. 215, at page 220). They have been cited and applied over and over again and, if they are kept firmly in mind, they dispose *in limine* of the argument which prevailed with Atkinson, J., and has been urged before your Lordships.

A consideration of the numerous cases that were cited shows that it is not always easy to decide whether it can be said of a particular expenditure that it satisfies Lord Davey's test. But it is significant that Counsel were not able to call to the attention of the House any case in which the Appellants' present contention had been put forward. For a long period of years large sums of money have been devoted to the litigation of Income Tax claims — the most acute minds of the legal and accountancy profes-

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(1) Page 280 *ante*.

(Lord Simonds.)

sions have been at the service of the taxpayers—yet the claim that such money was expended wholly or exclusively for the purpose of the trade appears never to have reached a court of law. The reason is not far to seek. It is that neither the cost of ascertaining taxable profit nor the cost of disputing it with the Revenue authorities is money spent to enable the trader to earn profit in his trade. What profit he has earned, he has earned before ever the voice of the tax-gatherer is heard. He would have earned no more and no less if there was no such thing as Income Tax. His profit is no more affected by the exigibility of tax than is a man's temperature altered by the purchase of a thermometer, even though he starts by haggling about the price of it.

It is in this sense that Lord Greene, M.R., used a phrase which was challenged by Counsel for the Appellants. " But his obligation ", he said, " to pay it (the tax) is his obligation as a subject and a taxpayer, and in " ascertaining the amount of his liability he is putting himself in a position " to discharge his duty to the Crown[1]." As a trader it is his job to make profits: as a taxpayer it is his duty, like that of any other subject, to pay taxes. It is as little a part of his trade to find out how much tax he must pay as it is a part to pay it when he has found out. In this respect he is in the same position as any other taxpayer under any other Case of any other Schedule. This aspect of the case may be examined more closely. Let me suppose that a trader, having been assessed to Income Tax in the sum of £X in a certain year, disputes the assessment, claiming that his taxable profit is not £X but a lesser sum, say £Y. Suppose further that he succeeded in his claim. I fail to see how he has by the expenditure that he incurred earned profit in his trade. His taxable profit has been reduced, that was the object of his expenditure. But what has this to do with his trading profit? If his trading profit is to be regarded as the same thing as his taxable profit (which it is not or is not necessarily), then his money has been laid out for the purpose of reducing his trading profit, a purpose difficult to ascribe to a trader and impossible to bring within the scope of the Rule. To use an expression of Rowlatt, J., unless the expenditure is at least intended to " bring grist to the mill " of the trader, it cannot within the meaning of the Rule be money laid out for the purpose of his trade[2].

Two cases only need specific mention. Upon both I respectfully concur in everything that has been said by the Master of the Rolls. In *Allen* v. *Farquharson Bros. and Co.,* 17 T.C. 59, certain observations of Finlay, J., were relied on by the Appellants. I would question whether that learned Judge intended to say anything that would support their contention. I do not doubt that as a practical matter the Revenue authorities allow accountancy charges as a deduction in computing profits, both because such charges are necessary for trading as well as tax purposes and it would be vexatious to distinguish between them, and because they must find their own task an easier one if they are dealing with professional men who speak their language and understand their art. I do not think it necessary to decide how far in this direction the Revenue authorites are bound to go. But, if Finlay, J., meant that an expense incurred solely for the purpose of dispute with the Crown could be deducted, then I must join with the Master of the Rolls in expressing my respectful dissent. In *Worsley Brewery Co., Ltd.* v. *Commissioners of Inland Revenue,* 17 T.C. 349, certain observations of

(1) Rushden Heel Co., Ltd. *v.* Keene, page 316 *post.*
(2) Union Cold Storage Co.. Ltd. *v.* Jones, 8 T.C. 725, at p. 736.

(Lord Simonds.)

Romer, L.J., have, as I think, been misunderstood and relied on. I need say no more than that I wholly agree with the explanation given by the Master of the Rolls and Morton, L.J., of this case.

It remains to consider the special reason advanced in this case for allowing the deduction of expenditure incurred in contesting a tax claim. Here again I am so fully in agreement with the learned Master of the Rolls that I need say little. If the expense of contesting a tax claim is not *per se* a deductible expense, I cannot accept the proposition that some special ulterior motive makes it deductible. I see that money has been laid out for the purpose of contesting a tax claim. I know, for I assume that to have now been decided, that money so laid out is not laid out wholly and exclusively for the purposes of trade. I do not understand by what process of reasoning the contrary result is reached and it is found to be wholly and exclusively laid out for the purposes of trade because there was an ulterior motive. This is to confuse motive with purpose.

Finally, upon the Income Tax appeal it was urged that, since under Section 18(1) of the Finance (No. 2) Act, 1939, the Excess Profits Tax that has been paid may for Income Tax purposes be deducted as an expense, so also should the cost of ascertaining the amount of the Excess Profits Tax be deductible. I have felt a good deal of sympathy for this argument, but have come to the conclusion that its attractiveness lies rather in its suggestion of what the Legislature might, subject to proper limits, have reasonably done, than in its correct interpretation of the Section. It is clear that but for the Section the Excess Profits Tax itself could not be deducted. Making express provision for that deduction, it is silent about the cost of ascertainment. I do not feel at liberty as a matter of construction to say that by implication the one is included in the other.

I would dismiss both these appeals.

Lord Normand.—My Lords, the questions in these appeals are whether the costs and expenses of a successful Excess Profits Tax appeal are a proper deduction in computing profits and gains either for the purposes of Income Tax or for the purposes of Excess Profits Tax.

But these questions can in effect be reduced to the single question whether the costs and expenses are deductible in computing the profits for the purposes of Income Tax, and it can also be said that it would have made no difference if the costs had been incurred in prosecuting an Income Tax appeal. Profits for Excess Profits Tax purposes are computed on Income Tax principles, and, though Excess Profits Tax is, under Section 18 of the Finance (No. 2) Act, 1939, allowed to be deducted in computing profits for the purposes of Income Tax, this express allowance, which does not extend to the costs and expenses of appeals, is, in my opinion, directed to limiting the total taxation of trade profits and distributing it between the two taxes in accordance with the intention of Parliament. Apart from the provisions of Section 18 of the Finance (No. 2) Act of 1939, Excess Profits Tax would not be deductible any more than Income Tax itself is deductible in computing profits for Income Tax purposes. The reason why Income Tax is not deductible in computing profits for Income Tax purposes is not merely the logical difficulty pointed out by Mr. Grant that, if it were, the computation would inevitably drift through the repetition of the deduction into the eddy of an indefinite process. There is the more substantial reason that Income Tax is an impost made upon profits after they have been

(Lord Normand.)

earned, and that unless the observations of Lord Davey in *Strong and Company of Romsey, Ltd.* v. *Woodifield,* [1906] A.C. 448 (5 T.C. 215), which have often been referred to and applied in later cases, are to be disregarded, a payment out of profits after they have been earned is not within the purposes of the trade carried on by the taxpayer. But Excess Profits Tax also is levied on profits after they are earned and, apart from the statutory provision, is *in pari casu* with Income Tax.

The issue is accordingly whether the costs and expenses of an Income Tax or an Excess Profits Tax appeal would properly be entered on the debit side of an account of disbursements and receipts framed for the purpose of arriving at the full amount of the profits and gains of a company's trade under Case I of Schedule D, or whether Rule 3(*a*) of the Rules applicable to Cases I and II of Schedule D prohibits their deduction as not being money wholly and exclusively laid out or expended for the purposes of the company's trade.

Every trading company must keep books of account and these books are used by the accountants for the purpose of making up the commercial profit and loss account. The accountants may use that account by applying to it the modifications which Income Tax law requires in order to bring out the profit for Income Tax purposes, and they may have to negotiate with Inland Revenue officials in order to justify their account of profits and perhaps to obtain a correction of an assessment. It will also be necessary to prepare an account showing the amount of the distributable profits after making provision for the Income Tax liability. As the first and last of these accounts are among the purposes of the trade, the taxpayer may say that the whole accounting process, including even the prosecution of an appeal in order to determine the correct Income Tax assessment, is carried out for the purposes of the trade, and it may be added that the proper conduct of the trade requires that the assessment shall be correct. On the other hand, it may be said that there is in strictness no part of the accounting process which is not directly or indirectly concerned with Income Tax liability and that, as the payment of Income Tax is not a purpose of the trade, none of the costs incident to the accounting process are laid out exclusively for the purposes of the trade. That would be an extreme and, I think, an untenable proposition. The Inland Revenue's contention in these appeals did not go nearly so far. It was that the costs and expenses of appeal proceedings before the Commissioners of Inland Revenue or the Board of Referees, and from them to the Courts, are not laid out exclusively for the purposes of the trade and are, therefore, not permissible deductions. The line drawn by the Inland Revenue would allow deduction of the costs incurred in negotiations with their officers before an appeal is taken, or where no appeal is taken, either as a concession to the taxpayer or as a practical and convenient settlement of a disputable point.

The costs of an appeal against an assessment are incurred at least in part, if not exclusively, for the purpose of reducing the payment which the taxpayer will have to make if he acquiesces in the assessment. The purpose of the appeal is not limited to correcting the assessment itself, for if the assessment involved no liability to pay, no one would go to the trouble and expense of appealing against it. So, even if the correction of the assessment is within the purposes of the trade, the expenses and

(Lord Normand.)

costs of the appeal are nevertheless laid out at least partly for a purpose which is not one of the purposes of the trade; they are accessory to the payment of a tax out of profits and are non-deductible because the tax itself is non-deductible.

As I understand the judgment of the learned Master of the Rolls, that is the ground on which he has decided the general question against the Appellants. I refer specifically to the following passage, which I would respectfully adopt: "I am prepared to assume (although I do not "so decide) that the ascertainment of the proper amount of tax payable "ought, as the Appellants argue, to be regarded as necessary for the "proper carrying on of the trade and, therefore, for earning of profits "in the future. But I cannot agree that the money can be said to have "been laid out 'wholly and exclusively' for that purpose. It was laid "out, as it appears to me, just as much if not more for the purpose of "ensuring that the Company, like any other taxpayer, should pay the "proper amount of tax, no more and no less.(1)" I agree also with the further observation that an accountancy expense incurred solely for the purpose of conducting a tax controversy with the Crown cannot be deducted.

In these appeals a subsidiary or alternative argument was presented, that the real purpose of the Excess Profits Tax appeal was to retain the services of a valuable employee. But the findings of fact do not go so far as this, they mean only that the directors had that in view as one of the objects of the appeal. Even if it was a principal object it would nevertheless not exclude the payment of the correct amount of tax as another important purpose of the appeal.

I would refuse the appeals.

Lord Oaksey.—My Lords, the question in this appeal is whether the costs of litigation undertaken for the purpose of arriving at the true profits of a trade for the purposes of taxation are proper deductions in order to arrive at the balance of profits and gains or as expenses wholly and exclusively laid out or expended for the purposes of the trade within the meaning of Rule 3(*a*) applicable to Cases I and II of Schedule D of the Income Tax Act, 1918. The contention on behalf of the Crown is that no expenses connected with taxation are deductible, because it is said they are not expended for the purposes of the trade, and it is sought to limit the words "the purposes of the trade" to the purpose of earning the profits of the trade by the operations of the trade.

Reliance is placed upon the dictum of Lord Davey in *Strong and Company of Romsey, Ltd.* v. *Woodifield*, [1906] A.C. 448 (5 T.C. 215), which has frequently been cited with approval in other cases, but it is to be observed that Lord Davey did not say "earning the profits by the "operations of the trade", and in my opinion the words "the purposes "of the trade" ought not to be construed in this way.

A trader does not expend money in an action brought for or against him for negligence or breach of contract in the course of his trade for the purpose of earning the profits of the trade in this sense, for it is not an operation of his trade to engage in litigation. It is, of course, an incident which he may think reasonably necessary for the

(1) Rushden Heel Co., Ltd. v. Keene, page 316 *post*.

(Lord Oaksey.)

purposes of his trade to bring or defend actions. But so it is an incident which he may think reasonably necessary for the purposes of his trade to engage in litigation as to the amount of his taxes. If he succeeds in either case he increases the profit arising from his trade, and it appears to me to be no straining of language to say that a trader who increases his profits by incurring a certain expense incurs that expense for the purpose of earning the profits.

In my opinion the real question which has to be decided in every case is whether the expense is one which is incurred in order to earn gain or profit from the trade or is the application of the gain or profit when earned (see per Lord Selborne, L.C., in *Mersey Docks and Harbour Board* v. *Lucas* (1883), 8 App. Cas. 891, at page 906, and 2 T.C. 25, at page 30), and in my opinion it cannot be truly said that the expense of paying accountants or of litigating the question of what is the balance of profits and gains for the purposes of taxation is the application of these profits. Profits cannot properly be applied or divided until they are ascertained, and every expense which is properly incurred for the ascertainment of profits is, in my opinion, an expense of earning the profits and not an application of them. That is not to say that all expenses which are incurred in point of time before the profits are ascertained can be deducted. The point of time is unimportant: some expenses which are clearly the application or distribution of profits may be incurred before the ascertainment of profits, for example, capital investments or payment of interim dividends. But it is the character of the expense which must be considered. The expense in this case was not a capital investment, it was incurred not to distribute but to increase and in that sense to earn the profits. On the other hand, if it is to be held that such expenses are not deductible, what is to be said of the costs of audit which the Companies Acts make necessary, or of that part of the cost of bookkeeping which is used in the preparation of such an audit, or of accounts for taxation ? They are not incurred for the purpose of earning the profits of the trade in the limited sense contended for by the Crown.

It is said that the expense of litigating questions of taxation has never been sought to be deducted, and it may be so, but it is also true that the expense of paying accountants and auditors has been deducted, and in any event the fact, if it be the fact, throws no legal light upon the construction of the words in question.

For these reasons I am in favour of allowing the appeals.

Questions put:

That the Orders appealed from be reversed.

The Not Contents have it.

That the Orders appealed from be affirmed and the appeals dismissed with costs.

The Contents have it.

[Solicitors:—Warren, Murton & Co.; Solicitor of Inland Revenue.]