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No. 1114—High Court of Justice (King's Bench Division)— 15th and 16th June, 1937

Court of Appeal—6th, 7th and 8th December, 1937, and 31st January, 1938

House of Lords—15th, 16th, 19th, 20th and 22nd June and 27th July, 1939

Commissioners of Inland Revenue *v.* Cull[1]

Sur-tax—Total income—Dividend declared payable " without " deduction of Income Tax "—Income Tax Act, 1918 (8 *&* 9 *Geo.* V, *c.* 40), *General Rule* 20; *Finance Act*, 1927 (17 *&* 18 *Geo.* V, *c.* 10), *Sections* 38 *and* 39; *Finance Act*, 1931 (21 *&* 22 *Geo.* V, *c.* 28), *Section* 7.

The Respondent was the holder of a number of ordinary shares in an unlimited company which, on 13th March, 1934, *passed a resolution " that an interim dividend for the year to 31st March, "* 1934, *on the Ordinary shares of twenty-one shillings per share be " paid on 31st March*, 1934, *without deduction of Income Tax ". Owing to previous losses the company was not liable to be charged to Income Tax under Case* I *of Schedule D for the year* 1933–34, *though it made considerable profits in that year which would become chargeable to Income Tax for the year* 1934–35.

The Respondent was assessed to Sur-tax for the year 1933–34 *on a sum which included the amount of the dividend so paid, with an appropriate addition for Income Tax.*

Held, *that, since the company had paid the dividend without exercising its optional right of deducting Income Tax (under Rule* 20 *of the General Rules of the Income Tax Act*, 1918), *the dividend had not been reduced to a " net amount " within the meaning of Section* 7 (2) *of the Finance Act*, 1931, *and no addition for Income Tax was needed in order to arrive at the amount returnable for Sur-tax purposes.*

Neumann *v.* Commissioners of Inland Revenue, [1934] A.C. 215; 18 T.C. 332, *followed.*

Commissioners of Inland Revenue *v.* Pearson *and* Commissioners of Inland Revenue *v.* Pratt, 20 T.C. 433, *disapproved.*

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[1] Reported (K.B.) 158 L.T. 201; (C.A.) [1938] 2 K.B. 109; (H.L.) [1940] A.C. 51.

CASE

Stated under the Income Tax Act, 1918, Section 149, and the Finance Act, 1927, Section 42 (7), 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 the 18th November, 1935, Mr. A. E. K. Cull, hereinafter called " the Respondent ", appealed against an assessment to Sur-tax for the year ending the 5th April, 1934, in the sum of £70,637.

2. Cull and Company is an unlimited company having a share capital of £800,000, divided into 700,000 preference shares and 100,000 ordinary shares all issued and fully paid. The Respondent is the holder of 20,000 ordinary shares of the Company as well as the holder of a large number of preference shares. A copy of the Company's Articles of Association is attached hereto, marked " A ", and forms part of this Case(1).

3. At a meeting of the directors (who are called " partners " in the Company's Articles of Association) held on the 13th March, 1934, the following resolution was passed :—

" It was resolved that the dividends on the 5 per cent. " Cumulative Preference shares for the four years to " 31st March, 1934, be paid on the 31st March, 1934, and " that an interim dividend for the year to 31st March, 1934, " on the Ordinary shares of twenty-one shillings per share be " paid on 31st March, 1934, without deduction of Income " Tax ".

4. In his return of total income for the purposes of assessment to Sur-tax for the year ending the 5th April, 1934, the Respondent included the sum of £21,000 as being the dividend received by him on his holding of ordinary shares in the Company. In making the assessment under appeal the Special Commissioners added the sum of £7,000 as representing Income Tax in respect of this dividend.

5. The dividend of £21,000 was not paid over to the Respondent in cash but in respect thereof a sum of £21,000 was credited to his personal account with the Company on the 31st March, 1934.

6. In the Company's profit and loss account for the year to the 31st March, 1934, a deduction is shewn of the sum of £99,114 on account of Income Tax before arriving at the figure of £559,374 which is carried to the balance sheet as the balance of net profit. It was stated in evidence that owing to previous losses the Company was not liable to be charged to Income Tax for the year ending the 5th April, 1934, and that the sum of £99,114 was intended to be a reserve for Income Tax which would become chargeable in

(1) Not included in the present print.

respect of the next financial year which would be assessed on the basis of the Company's profits for the year to the 31st March, 1934. A copy of the balance sheet and profit and loss account of the Company for the year to the 31st March, 1934, is attached hereto, marked " B ", and forms part of this Case[1].

7. It was contended on behalf of the Respondent :—

(a) that the dividend on the ordinary shares of the Company authorised by the resolution of the 13th March, 1934, was not a "tax free" dividend but a dividend of twenty-one shillings per share from which the Company was entitled but not bound to deduct Income Tax;

(b) that the dividend actually received by the Respondent was a gross and not a net amount and consequently the provisions of Section 7 (2) of the Finance Act, 1931, were inapplicable;

(c) that the Company not having deducted Income Tax from the dividend, no addition on account of Income Tax ought to be made.

8. It was contended on behalf of the Appellants :—

(a) that the dividend on the ordinary shares of the Company authorised by the resolution of the 13th March, 1934, was a " tax free " dividend, and that the addition of Income Tax to the amount actually received by the Respondent had been correctly made;

(b) alternatively, that the dividend actually received by the Respondent had been paid out of a fund of income diminished by a reserve for Income Tax, and that the appropriate addition for Income Tax had been correctly made in accordance with Section 7 (2) of the Finance Act, 1931;

(c) that the assessment was correct and ought to be confirmed.

9. We, the Commissioners who heard the appeal, gave our decision in the following terms :—

" A shareholder can have no claim or title to any part of a " company's profits unless and until the company has duly " authorised the distribution of a dividend, and the terms of " the authorisation determine the amount which the share- " holder can claim. On payment of a dividend a company is " authorised but not compelled to deduct Income Tax.

" In the case of a ' tax free ' dividend, for the purpose of " Sur-tax the amount to be added to the dividend actually " received by a shareholder is an amount representing Income " Tax which has been deducted by the company from the

[1] Not included in the present print.

"dividend leaving the amount specified in the resolution (*see* "*Gold Fields American Development Co., Ltd.* v. *Consolidated* "*Gold Fields of South Africa, Ltd.*, [1926] Ch. 338, at "page 356).

"In the case before us it is contended on behalf of the "Crown that in the resolution of 13th March, 1934, the words "'without deduction of Income Tax' should be read as 'after "'deduction of Income Tax', and that the dividend is a "'tax free' dividend. In our opinion the words 'without "'deduction of Income Tax' qualify the words 'be paid' "and mean that no deduction on account of Income Tax is "to be made on payment of the dividend of 21*s*. per share. "Accordingly, we hold that the dividend is not a 'tax free' "dividend, that no Income Tax has been deducted by the "Company, and that no addition to the dividend should be "made on account of Income Tax. We, therefore, reduce the "assessment by the sum of £7,000".

10. The representative of the Appellants immediately after the determination of the appeal declared to us his dissatisfaction therewith as being erroneous in point of law and in due course required us to state a Case for the opinion of the High Court pursuant to the Income Tax Act, 1918, Section 149, and the Finance Act, 1927, Section 42 (7), which Case we have stated and do sign accordingly.

H. H. C. GRAHAM, } Commissioners for the Special
G. R. HAMILTON, } Purposes of the Income Tax Acts.

York House,
23, Kingsway,
London, W.C.2.

16th March, 1936.

The case came before Finlay, J., in the King's Bench Division on the 15th and 16th June, 1937, and on the latter date judgment was given in favour of the Crown, with costs.

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

JUDGMENT

Finlay, J.—In this case I have arrived at a conclusion different from that of the Special Commissioners. I should like to say this: I have had an advantage which they had not, because I have been guided by a decision of my brother Lawrence in two very recent

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cases, the case of *Commissioners of Inland Revenue* v. *Pearson*(1), and the case of *Commissioners of Inland Revenue* v. *Pratt*(1). I do not say—indeed I do not think—that but for those cases, if I had not been guided by those cases, my decision would have been different from what it is, but if it were not for those cases I certainly should have thought it necessary to give this matter, which is both important and difficult, rather more elaborate consideration than I think is necessary in the light of that decision.

The matter has reference to the case of a Mr. Cull, and he appealed against an assessment to Sur-tax for the year ending the 5th April, 1934. Cull & Company is an unlimited company with a share capital of £800,000; there are preference shares and ordinary shares. The Respondent in addition to having a number of preference shares held 20,000 ordinary shares. At a meeting of the directors on the 13th March, 1934, the following resolution was passed, and it is on that that this matter in the main turns: "It was "resolved that the dividends on the 5% Cumulative Preference "shares for the four years to 31st March, 1934, be paid on the 31st "March, 1934, and that an interim dividend for the year to "31st March, 1934, on the Ordinary shares of twenty-one shillings "per share be paid on 31st March, 1934, without deduction of "Income Tax". The Respondent, Mr. Cull, included the sum of £21,000 in his return as being the dividend received by him, and the claim of the Revenue is that that was not the proper sum, but that there fell to be added to it a sum of £7,000 which they said represented the Income Tax in respect of the dividend. The Company's profit and loss account was exhibited. It is not necessary to go into it in any detail. The only fact which I think is material to state, because some reliance was placed upon it, is this: that in the year in question no tax—at all events no tax under Case I—was payable. That arose from the fact, apparently, that in the years previous to that upon which the assessment was based the Company had in fact made a loss. What I have said should perhaps be taken with this qualification—the matter to which Mr. Tucker in his able argument drew my attention—that there appear to have been received in the year of assessment certain dividends, and I am told nothing special about them, but they doubtless would be received under deduction of tax, and in that sense tax would no doubt be paid by the Company in the year of assessment. But the large profits made by the Company in the year 1933–34 would not, by reason of the position in the previous years, attract tax, but would, of course, fall to be assessed and taxed in the following year. That the Company appreciated that fact is very clearly shown by the circumstance that it put aside to Income Tax reserve a large sum, about £90,000 I think, to be used no doubt to meet the tax in the following year, to pay the tax for that year, the tax based as it would be upon the profits of the year 1933–34.

(1) 20 T.C. 433.

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The point in the case has a rather deceptive air of simplicity. As a matter of fact, these questions have led to a very great amount of difficulty; but although the point is not easy to solve, it can be stated with very great conciseness. It is this : the Revenue say that what this gentleman received was not merely the dividend, which I will call x, but a sum of x plus y—the y being the tax upon that dividend. What he himself says is that he did not receive y and that on the true view here all that he received and all that he is liable to bring in for the purpose of Sur-tax is the sum of x. Now I do not propose, for the reason which I have indicated at the beginning of my judgment and which I will develop in a few moments, to go in great detail or in any detail either through the cases on this subject or through the various statutory provisions which have been made. The general position is quite plain, and it is this: the company is liable to pay tax upon all its profits. The method of computation—what particular years or particular periods may be taken—seems to me to be immaterial. The point is that the company, the body which is face to face with the taxing authorities, has got to account for all its profits. The company in paying tax does not pay, I think, as agent for its shareholders. That view was at one time held, and I think a great authority, Scrutton, L. J., in some judgment I recollect, said(1) that the true view was that the company paid as agent for its shareholders. I do not think that is correct, and I think there is a passage in a speech of Lord Cave in the House of Lords(2) which disposes of that view and which shows that the company paying the tax pays simply because it is a person which has made profits and which has got to pay tax. But it is quite clear that the company paying tax then acquires a right to deduct, in paying dividends, a proportionate part of the tax from the dividend which it pays. It may do that or it may not. It is not bound to deduct the tax; but it seems to me to be quite clear that if it chooses not to exercise its right then it is simply paying an additional dividend to the person entitled to the dividend. I say that because I think it was settled in a very leading case, *Ashton Gas Company* v. *Attorney-General*(3), and that case went to the House of Lords, and all the Courts were unanimous on the matter. But the judgment very often referred to—indeed generally referred to—is the judgment of Buckley, J., where he points out(4) that the shareholder receiving a dividend of 10 per cent. free of tax receives 10 per cent. and an indemnity against a liability to pay tax. It is quite true, and it has been settled, that the dividend itself is not liable to tax in the hands of the shareholder; that does not matter, because though he is not liable to direct assessment on the dividend, he is liable to suffer the tax by way

(1) Brooke *v.* Commissioners of Inland Revenue, 7 T.C. 261, at p. 276.
(2) Commissioners of Inland Revenue *v.* Blott, 8 T.C. 101, at p. 136.
(3) [1906] A.C. 10. (4) [1904] 2 Ch. 621, at p. 623.

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of deduction. That to my mind is quite plainly the general position of the law. One has got just to look at the resolution which was here passed. I do not go through, as I said I would not, the various provisions in the Acts, though I shall have occasion to refer to one at least of them later. Here what was done was that a dividend of 21*s*. per share was paid without deduction of tax. For myself I am quite unable to differentiate or to draw any distinction between the words "free of Income Tax" and the words "without "deduction of Income Tax". They seem to me to mean the same thing, and what they mean is this, that the Company is paying to the shareholder the dividend *x* and in addition it is paying over what Buckley, J., called the indemnity—that is to say, a sum which can be measured in money—*y*—which is, so to speak, an immunity from tax, tax by deduction, it is true, but none the less tax.

I have referred to the *Ashton Gas Company* case([1]). Several other cases were brought to my attention, one of which was the case of *Gimson*([2]), a decision of Rowlatt, J., which was held by two members of the House of Lords to be correct([3]), differing in that respect from the Court of Appeal([4]), but that case to my mind has no bearing upon the present. So far I should have thought that the matter was quite simple, but the difficulty which arises and which to my mind is solved by the decision of my brother Lawrence in the cases at which I shall have to look in a few moments, is caused not by the main part of the decision of the House of Lords in *Neumann* v. *Commissioners of Inland Revenue*, but by the decision of the House of Lords, which is, of course, binding, on a minor and subordinate point. But in the *Neumann* case the law on the whole subject is elaborately reviewed, particularly in the speeches of Lord Tomlin and Lord Wright, and Lord Tomlin lays down the law in terms a sentence or two of which I will read. He says this([5]): "the deduction permissible from the dividend clearly "had no relation to the figure of tax payable by the company to "the Revenue, though there was still no obligation on the company "to account to the Revenue for what was deducted. The deduction, "in fact, was only part of a system by which were measured (1) the "extent of the shareholders' right to have exemption or abatement, "and (2) the liability of the shareholder to Sur-tax". After that, Lord Tomlin goes on to read the rather modern Section, Section 7 of the Finance Act of 1931, to which I shall make brief reference. I have indicated that a difficulty does arise with reference to the decision on the second point in *Neumann's* case, but to my mind, as far as I am concerned, sitting here, that difficulty is resolved

(1) [1904] 2 Ch. 621, and [1906] A.C. 10.
(2) Gimson *v.* Commissioners of Inland Revenue, 15 T.C. 595.
(3) Neumann *v.* Commissioners of Inland Revenue, 18 T.C. 332, at pp. 363 and 370. (4) *Ibid.*, at pp. 346, 349 and 351. (5) *Ibid.*, at p. 361.

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by the decision of my brother Lawrence (this is what enables me to shorten my judgment in the present case) in these two cases, *Commissioners of Inland Revenue* v. *Pearson*(1) and *Commissioners of Inland Revenue* v. *Pratt*(1). It was said by Mr. Tucker that there was a distinction in fact between those cases and the case which is now before me, and the distinction suggested was this: that in the present case there were no profits—at all events no profits directly liable to assessment in the year—whereas that was not the case in either of those cases. In both of those cases tax on the profits had been paid, as my brother Lawrence expressed it(2), pound for pound, and the profits brought into tax in those cases exceeded the amount which was distributed in dividend. For reasons which I will indicate in a few moments, I do not think that distinction really affects the matter, but even if there were a distinction in fact, even if there were a material distinction, none the less I think that the reasoning of my brother Lawrence really affords a guide which solves the difficulty—I frankly admit a serious difficulty—which arises with reference to the second point decided by the House of Lords in *Neumann's* case(3). What Lawrence, J., says is this(4): "The basis of that decision is, in my opinion, that "their Lordships there considered that, the taxable profits of the "company having been taxed under Schedule A, and dividends "declared thereout less tax, the remainder of the actual profits "which was specially segregated in a reserve fund could not be "exceeded even for the purpose of the shareholders' Sur-tax when "it came to be divided, because it was all that remained, the rest "of the profits having been comprehensively dealt with before". Lawrence, J., goes on to cite in support of that view passages from Lord Tomlin and Lord Wright(5), and Lord Wright there says that the case is unusual because the fund had been segregated and divided *in toto*, and my brother Lawrence appears to me to have distinguished there *Neumann's* case as to the second part of the decision on that ground; that is to say, he regarded it as being a special case dependent upon the view that a fund had been segregated, and therefore (and this is what appears, judging from what they said, to have impressed both Lord Tomlin and Lord Wright) the extra money, so to speak, regarding the fund as segregated, was not there. Now that appears to me to be the view and the basis upon which my brother Lawrence distinguished *Neumann's* case, and I propose, without saying more about it on this part of the matter, to follow him in that. The substance of what he there said was that in his opinion the case was governed by the *Attorney-General* v. *Ashton Gas Company* case(6), the general principle there laid down, and indeed I did not understand that that general principle was disputed or could be disputed, and he dealt, as

(1) 20 T.C. 433. (2) *Ibid.*, at pp. 443 and 444. (3) 18 T.C. 332. (4) 20 T.C., at pp. 443/4. (5) 18 T.C., at pp. 364 and 373. (6) [1906] A.C. 10.

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I propose to deal, with the difficulty caused by the decision on the second point in *Neumann's* case(1) by saying that that depended upon the special facts and upon the segregation of a fund. It is not necessary for me to develop that further, because, as I say, I am content to follow my brother Lawrence, and more particularly because I agree with the view he takes that when the matter is understood it is seen that this case can be decided by applying the principle laid down so many years ago by Buckley, J., in the *Ashton Gas* case(2).

The only other thing I want to say is this: I should be for myself content to assume that there was a distinction in the facts —a material distinction in the facts—between the cases which my brother Lawrence decided(3) and the present case. If I thought so, I should none the less agree with the reasoning that Lawrence, J., applied, and I should follow it and apply it, but I do not think that the distinction to which my attention was properly directed really affects the matter at all. What was said was this: that in those two cases there were in fact profits assessable to tax and assessed to tax and that out of those profits the dividends were paid. Here it is pointed out to me that, apart from the matter of the taxed dividends, though some eventualities have to be enquired into, there were no taxable profits in the year in which the payment was made. I do not think that that makes any difference, and I say that for two reasons. In the first place, it seems to me that the point is met by the passage from Lord Tomlin's speech which I read earlier(4), and it was for that reason that I read it; and in the second place it seems to me that this matter is precisely dealt with by Section 7 of the Act of 1931, which amends Rule 20 of the General Rules. That Section, whatever may have been doubtful before, seems to me to make it clear that where you get, as you do get, what one may call the Income Tax price, then the fact that the profits do not happen to be assessable in the year in question is immaterial. I therefore think that the distinction between the cases decided by my brother Lawrence and the present case does not affect the matter.

I have been at some greater length than I intended into the matter, but for myself, and apart from authority, the case seems to me, and would seem to me certainly, but for the fact that I am differing from very experienced Special Commissioners, to be rather simple. I repeat that I am unable to distinguish between the words " without deduction of tax " and the words " free of tax "; and it seems to me that the principle of the matter is that the Company is giving to the shareholder not only the dividend of 21*s*. per share but is in addition giving to him a thing which can be

(1) 18 T.C. 332. (2) [1904] 2 Ch. 621. (3) Commissioners of Inland Revenue *v.* Pearson, and Commissioners of Inland Revenue *v.* Pratt, 20 T.C. 433
(4) *See* p. 609 *ante*.

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measured in money, namely, the immunity from tax—giving what Mr. Tucker quite rightly called a present. It is a present in the same sense that the dividends are a present. The Company is not bound to declare a dividend, and the shareholder has no right to the dividend until it is declared. In the same way, the Company has a perfect right in declaring a dividend to say that the tax will be deducted from the dividend. Here it chooses not to do that, and in not doing that it seems to me that it is not only giving to the shareholder 21*s*. in the pound but is also giving to him an immunity, which can be measured in money, from Income Tax.

On these grounds I am of opinion that this appeal succeeds.

The Attorney-General.—The appeal will be allowed with costs, my Lord?

Finlay, J.—Yes, the appeal will be allowed with costs.

The Attorney-General.—I am told that the assessment was reduced by £7,000.

Finlay, J.—I suppose it should be restored, should not it?

The Attorney-General.—Yes, restored to the original figure.

Finlay, J.—Mr. Tucker, the assessment has been reduced. If my decision is right, it ought to be restored to the original figure?

Mr. Tucker.—Yes, that is so, my Lord.

An appeal having been entered against the decision in the King's Bench Division, the case came before the Court of Appeal (Sir Wilfrid Greene, M.R., Lord Romer and MacKinnon, L.J.) on the 6th, 7th and 8th December, 1937, when judgment was reserved. On the 31st January, 1938, judgment was given in favour of the Crown (Lord Romer dissenting), with costs, confirming the decision of the Court below.

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

JUDGMENT

Sir Wilfrid Greene, M.R.—The Appellant is the holder of 20,000 ordinary shares in Cull & Co., an unlimited company incorporated under the Companies Acts. On the 13th March, 1934, the directors of the Company declared an interim dividend on its ordinary shares for the year ending 31st March, 1934, of 21*s*. per share "without "deduction of Income Tax". The Appellant was assessed to Sur-tax for the year ending 5th April, 1934, and for the purpose of the assessment the Special Commissioners added to the amount of the ordinary dividend which had been credited to him, namely, £21,000, a sum of £7,000 as representing Income Tax in respect

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of the dividend. The addition of Income Tax to a net dividend for the purpose of Sur-tax assessment is commonly referred to as "grossing up" the dividend, and in this judgment I will use this convenient though ill-sounding expression. The Appellant appealed against the assessment upon the ground that, as the dividend had been declared "without deduction of Income Tax", it was not legitimate to "gross it up", that process being (in his contention) only permissible in cases where Income Tax is deducted from the dividend. The Special Commissioners allowed his appeal, but their decision was reversed by Finlay, J., from whose judgment the present appeal is brought.

Before I proceed to consider the question raised by the appeal, certain facts must be stated with regard to the Company's accounts. The Company's profit and loss account for the year ending 31st March, 1934, showed a net profit of £559,374 2*s*. 1*d*. In the years immediately preceding it had traded at a loss, the accumulated losses being £239,188 3*s*. 2*d*., and as the result of this position the Company was not liable to be charged to Income Tax under Schedule D for the year ending 5th April, 1934. The balance standing to the credit of profit and loss account as at the 31st March, 1934, after deducting these accumulated losses, was £320,185 18*s*. 11*d*., of which £20,000 was transferred to reserve, £105,000 was utilised in paying four years' preference dividends on the preference shares of the Company, while the ordinary dividend exhausted a further £105,000, leaving £90,185 18*s*. 11*d*. to be carried forward. Before arriving at the profit and loss figure of £559,374 2*s*. 1*d*., provision was made for Income Tax in the sum of £99,114 9*s*. 7*d*. This sum was intended to form a reserve against Income Tax which would become chargeable in respect of the next financial year. The making of this provision was not a deduction of Income Tax from the dividend declared, and for present purposes it may, upon my view of the case, be disregarded. Equally irrelevant is the fact that during the year in question the Company received dividends on investments from which tax was deducted at the source.

The only fact of importance which emerges from the accounts is that the Company had ample funds to enable it, if it had so desired, to declare a dividend of 21*s*. per share on its ordinary shares "tax "free". If the declaration had taken this form it would admittedly have been equivalent to the declaration of a dividend of such an amount as after deduction of Income Tax would have produced a net dividend of 21*s*., payment of 21*s*. would have been a payment after deduction of tax, and it would have been necessary for Sur-tax purposes to "gross up" the 21*s*. by adding to it the amount of the tax so deducted (*see Gold Fields American Development Co., Ltd.* v. *Consolidated Gold Fields of South Africa, Ltd.*, [1926] Ch. 338, at page 356).

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The question which arises on this appeal is whether or not, upon the true construction of the relevant statutory provisions and in the circumstances of the case, the declaration and payment of the dividend were, in law, equivalent to the declaration and payment of a dividend of 21*s.* " tax free " notwithstanding that, upon its face, the declaration purported to be a declaration of a dividend of 21*s.* " without deduction of tax ". The contention of the Appellant can be concisely stated. It is that a company is entitled to deduct or not to deduct tax at its option; that the question which alternative it has chosen is to be decided by reference to the action of the company itself; that in the present case the declaration upon its true construction demonstrates that the company has elected not to deduct tax; and that, under the relevant statutory provisions, a dividend may only be " grossed up " for Sur-tax purposes where the company has in fact deducted tax. In support of this conclusion it is said that, whereas when the company deducts tax the share of profits which the shareholder receives is, for tax purposes, a previously existing gross sum of which the Crown is to be treated as having received a part, when no tax is deducted the shareholder cannot be treated as having received a gross sum, since no such gross sum ever existed or can be treated as having existed.

The application of the provisions of the Income Tax Acts relating to dividends paid by incorporated companies is a subject which bristles with difficulties. They originate in Section 54 of the Income Tax Act, 1842. At the date when that Act was passed there was some excuse for the apparent simplicity of the Section, but, with the growth of limited companies, difficulty after difficulty appeared. The Section contemplated a very simple procedure. The tax was charged on the "body of persons" which, in due course, would divide up the balance of its profits which remained after payment of the tax. Upon such division the persons entitled to share in the profits were to be bound to allow out of the dividend " a proportionate deduction in respect of the duty so charged ". But the Section applied to all bodies of persons whether incorporated or unincorporated. In the case of unincorporated bodies no particular difficulty appears to have presented itself. This was far from being the case with incorporated bodies. In its application to these latter bodies the Section could only work if some method could be found of reconciling two fundamentally different conceptions, namely, that of a body of persons paying a share of profits to the persons entitled to those profits as such, and that of an incorporated body of persons paying dividends to its members who have no right to the profits as such at all. A dividend paid by a limited company to its members is in its nature quite different from a share of profits. This fact arises from the very circumstance of incorporation. But the Section treats that circumstance as

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irrelevant, and provides no method of resolving the fundamental antinomy. The fact that dividends are often paid in whole or in part out of profits of past years; changes in the rate of tax; the operation of the statutory provisions for measuring profits by reference to the results of previous years—raised questions which have puzzled the Revenue, the companies concerned and the Courts. The Legislature, instead of starting afresh with a logical system, has contented itself with patchwork designed to deal with particular difficulties as they emerged. Thus Section 39 of the Finance Act, 1927, dealt with the difficulty caused by differences in the rate of tax. Section 7 of the Finance Act, 1931, dealt with the difficulty caused by the fact that dividends may be paid out of the profits of a year in which the profits as assessed to tax are nil, or less than the actual profits divided. There is also a strong body of opinion in favour of the view that the law was altered in 1918 when Rule 20 of the General Rules was substituted for Section 54 of the Act of 1842 (*see per* Lord Tomlin in *Neumann* v. *Commissioners of Inland Revenue*, 18 T.C. 332, at page 360; *Gold Fields American Development Co., Ltd.* v. *Consolidated Gold Fields of South Africa, Ltd.*, [1926] Ch. 338, at page 347; *F. H. Hamilton* v. *Commissioners of Inland Revenue*, 16 T.C. 213, at page 228, *per* Lord Hanworth, M.R., and at page 233, *per* Lawrence, L.J.).

The resulting scheme of legislation might appear to have succeeded in providing a practical solution of the fundamental antinomy to which I have referred. A company pays tax on its profits measured by the rules for the time being in force. It pays a dividend out of its profits. In making the payment it is entitled to deduct tax at the standard rate current at the time, irrespective of the rate of tax prevailing when the profits were made, and irrespective of the fact that for the year in which the dividend is paid the profits as assessed to tax may be nil, or less than the actual profits of the year used for payment of the dividend. The shareholder for all purposes of his return of total income is treated as having received a dividend equal to the net amount plus the tax deducted; that is, his dividend is " grossed up " by adding back the tax.

This scheme is sufficiently well adapted to work in the ordinary case where dividends are paid less tax or " tax free ", and it might have been thought that all troubles were at an end. This was not so, for a problem of great difficulty arose almost at once in *Neumann's* case. It is upon the decision in that case that the argument of the Appellant is based, for it is said on his behalf that *Neumann's* case laid down a general rule to the effect that the provisions as to " grossing up " contained in Sub-section (2) of Section 7 of the Finance Act, 1931, only apply when tax is in fact deducted by the company, and that, as in the present case no tax was deducted, there can be no " grossing up ". The

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decision in *Neumann's* case(1) must accordingly be examined with care. But in order to make any such examination intelligible it is necessary to have in mind the language of Rule 20 of the General Rules and Section 7 of the Finance Act, 1931, which I accordingly quote : Rule 20 : " The profits or gains to be charged on any body " of persons shall be computed in accordance with the provisions " of this Act on the full amount of the same before any dividend " thereof is made in respect of any share, right or title thereto, and " the body of persons paying such dividend shall be entitled to " deduct the tax appropriate thereto ". Finance Act, 1931, Section 7 (1) : " The provisions of Rule 20 of the General Rules, " which authorise the deduction of the appropriate tax from any " dividend paid by a body of persons, shall, in relation to a dividend " paid by any body of persons, whether before or after the com- " mencement of this Act, be construed as authorising the deduction " of tax from the full amount paid out of profits and gains of the " said body which have been charged to tax or which, under the " provisions of the Income Tax Acts, would fall to be included in " computing the liability of the said body to assessment to tax " for any year if the said provisions required the computation to " be made by reference to the profits and gains of that year and " not by reference to those of any other year or period ". Sub-section (2) : " Subject as hereinafter provided, a dividend paid by " a body of persons, whether before or after the commencement of " this Act, shall, to the extent to which it is paid out of such " profits and gains as are mentioned in subsection (1) of this " section, be deemed, for all the purposes of the Income Tax Acts, " to represent income of such an amount as would, after such " deduction of tax as is authorised by the provisions of the said " Rule 20, be equal to the net amount received : Provided that the " provisions of this subsection shall not apply to a preference " dividend to which section twelve of the Finance Act, 1930, " applies, and shall have effect subject to the provisions of sub- " section (3) of that section ".

Now in order to understand *Neumann's* case it must be remembered that the question which it raised flowed directly from the decision in the *Salisbury House* case(2). The company made profits out of the rents received from tenants largely in excess of the Schedule A assessment. The Crown, in the *Salisbury House* case, claimed that these excess profits were assessable, but the claim was negatived by the Courts upon the simple and, one would have thought, obvious ground that the Schedule A assessment covered all the profits derived from ownership of land and the fact that the actual profits might exceed or fall below the figure of the assessment was immaterial.

(1) 18 T.C. 332. (2) Salisbury House Estate, Ltd. v. Fry, 15 T.C. 266.

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If the property in question in that case had belonged to an individual, no difficulty would have arisen with regard to his Sur-tax assessment. He would have included in his return of total income the amount of the Schedule A assessment and nothing more. But as the owner was a limited company the old difficulty once again raised its head. The company distributed two dividends. Upon the first of these an amount equal to the Schedule A assessment was distributed under deduction of tax. The second distribution was made out of a sum set aside in the accounts to represent surplus rents in excess of the Schedule A assessment. Upon this distribution no tax was deducted. The Crown claimed to be entitled to have the amount of the second dividend " grossed " up ". The taxpayer claimed that he was not liable to be assessed to Sur-tax at all in respect of the second dividend. Neither claim succeeded. It is with the decision on the Crown's claim that we are primarily concerned. With regard to the decision upon the taxpayer's claim, it is only necessary to point out in passing that the result necessarily flowed from the antinomy to which I have referred and the patchwork provisions enacted by the Legislature in order to remove the more glaring difficulties to which it led. In the result a fund of profits which, if received by an individual, would have been measured and franked for all tax purposes by the Schedule A assessment, when passed through the company and used to pay a dividend to its shareholders, attracted Sur-tax in their hands. The Legislature had apparently failed to remember and make provision for the special nature and effects of Schedule A in the case of land-owning companies. In consequence the shareholder in such a company is subjected to a burden which individual landowners are not called upon to bear.

But upon the question of " grossing up ", the House of Lords was able so to construe Sub-section (2) of Section 7, Finance Act, 1931, as to avoid a result which, in the words of Lord Tomlin[1], would have been " repellent to most minds ". The effect of " grossing up " the second dividend would have been to treat the company as having had a larger sum to distribute than it in fact had, and the shareholder as having received, in the shape of cash and tax, a sum greater than he did so receive. In paying the second dividend the company exhausted the excess rents, and to have treated the dividends paid as representing a larger gross sum from which tax had been deducted would have been to fly in the face of the facts. There never was in fact a deduction; there could not have been a deduction once it was decided to distribute the whole of the excess rents in cash among the shareholders.

I apprehend that the same result would have followed if the company had distributed in one dividend the whole of its profits from rents which remained in its hands after payment of the

(1) 18 T.C. 332, at p. 364.

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Schedule A tax. In that event it would have distributed a " net " amount, for it would have " deducted " tax, namely, an amount equal to the Schedule A tax which it had itself borne. But to have " grossed up " the dividend actually received by adding back a larger sum for tax would again have involved the false assumption that the fund available for distribution was greater than it in fact was. Some of the expressions used in the opinions delivered do not perhaps fit such a case. But I cannot bring myself to believe that the result would have been different. If the language of General Rule 20 were the same as that of Section 54 of the Act of 1842 the solution of these problems would have been simpler, for the deduction of the Schedule A tax from the dividends would have been " a proportionate deduction in respect of the duty so charged ". It is open for the consideration of the House of Lords whether the difference in language has the result which it is said to have in the authorities to which I have referred in an earlier part of this judgment.

The manner in which the actual problem in *Neumann's* case[1] was solved can best be seen by quoting the actual words of the opinions delivered by the House. Lord Tomlin, at page 364, said: " The question, however, remains as to the figure at which it is " to be brought in. I think it would be repellent to most minds " that the Appellant should be charged as a part of his income with " a sum which not only has never come to him but has never " existed in fact. It is plain that the Respondents' cross-appeal, " which seeks to treat the sum of £4,275 as a net sum, corre- " sponding to a gross sum of £5,343 15*s*., assumes that the amount " divisible by the company was something in excess of anything it " ever had to divide. It is said, however, that Section 7 (2) of " the Finance Act, 1931, compels the conclusion that the sum of " £5,343 15*s*. is the correct figure to be brought into computation. " I do not think that the effect of the statutory provision is as " contended for by the Respondents. The Sub-section, in effect, " provides that it is the gross amount before deduction which is " to be treated as the income for the purposes of the Acts. If a " deduction from the gross sum was authorised but was not in " fact made, as was the case here, there is, in my opinion, nothing " in the language of the Sub-section which entitles the Inland " Revenue to treat the gross sum as being greater than in fact it " was. From the Income Tax point of view, it makes no difference to the Revenue whether the deduction is made or not, because " the company does not have to account for what it deducts ".

Lord Warrington of Clyffe said, at page 366: " This brings me " to the second question, namely, at what figure is the dividend " to be brought in? Here, again, I agree with my noble and

(1) 18 T.C. 332.

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" learned friend. In such a case as this, namely, where no deduc-
" tion is in fact made, there is no distinction between a gross sum
" and a net sum. The actual sum paid, and not some wholly
" fictitious sum, is, therefore, that which should be included in
" the return of income ".

Lord Wright said, at page 373: " But the present case has
" proceeded on the basis of a specially segregated fund, the whole
" of which was distributed without any deduction for tax, nor
" was the dividend, in fact, nor could it be, described as ' tax
" ' free ', a phrase which is used to indicate that the dividend
" is net and under prior deduction of tax. Such a case as the
" present is unusual, because a fund has been segregated and
" divided *in toto*; hence, if the company had deducted tax, it would
" have been from a gross amount, not of £5,343 15*s*. 0*d*., but of
" £4,275, and equally, if the dividend had been ' tax free ', it
" would have been a dividend of the net amount after the appro-
" priate deduction of tax had been made from the sum of £4,275.
" Furthermore, in the company's hands, no greater sum in respect
" of this fund was chargeable to Income Tax than £18,325, of
" which £4,275 was the Appellant's *aliquot* proportion. What
" was distributed—being £4,275—was, in my judgment, the gross
" amount; the company, though authorised to deduct tax from
" it, was not bound to deduct it and did not in fact do so. I cannot
" see any justification for describing the sum distributed as a
" ' net amount ' and, hence, I conclude that Section 7 (2) does
" not apply. I cannot treat the word ' net ' as mere surplusage or
" as simply meaning the actual amount, whether gross or net ".

It is not surprising that the language used in these passages should have led to the argument that in no case where tax is not in fact deducted on payment of a dividend can there be a " grossing " up " under Section 7 (2), for the expressions used are general in character. But so to construe them would lead to very far-reaching results which the Legislature can scarcely have intended. For every company, by stating in its dividend declaration that no tax is to be deducted, could free its shareholders from a substantial liability to Sur-tax which they would have incurred if precisely the same amount of cash had been paid to them under a declaration of dividend " tax free ". If that is the effect of the decision in *Neumann's* case(1) it must be loyally followed. But I cannot bring myself to think that the members of the House of Lords intended, by the language which they used in a very special case, to produce such sweeping consequences.

There is, in my opinion, a fundamental difference between the facts in *Neumann's* case and those in the present case, namely, that in the present case the fund of profits available for distribution

(1) 18 T.C. 332.

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was more than sufficient to provide a sum equal to the cash actually distributed, plus the tax thereon; that is, the company could have declared a dividend of 21*s*. per share " tax free " without in any way departing from the realities of the case. As has already been pointed out, this could not have been done in *Neumann's* case(1), since to have done so would have involved the assumption that the company had made more gross profits than it in fact had made. It is in reference to this essential fact that the language in *Neumann's* case was used. It was this fact that made it impossible to describe the amount received by the shareholder in that case as a " net amount ".

But it is said that it is equally impossible to describe as a " net amount " the amount received by the Appellant in the present case, since no tax was deducted and it is only when tax is deducted that the amount received by the shareholder can properly be described as a " net amount ". The argument is an attractive one and I feel its force, but it appears to me to depend upon an assumption as to the meaning of the word " deduct ", the correctness of which I will endeavour to examine. That assumption is that in order that there may be a deduction there must be in terms, or by conduct, an exercise by the company of the right to deduct which is said to be given to it by General Rule 20.

The word " deduct " in Rule 20 does not mean that some specific sum is to be taken away and set apart, any more than does the same word in General Rule 19. When the latter Rule says that the person paying yearly interest shall be " entitled . . . . " to deduct and retain thereout a sum representing the amount of " the tax thereon ", it merely means that the payment of the net sum is to be a good discharge as between payer and payee. The language used in Rule 20 is similar to that used in Rule 19. If a company declares a dividend at the rate of £5 per cent. on its Ordinary capital it obtains a good discharge from the shareholder in respect of the debt so created if it pays £5 less tax. There is no need to refer to tax in the declaration—indeed this is never done in practice save where the dividend is declared " tax " free ", which is nothing more than a convenient formula for declaring a larger gross dividend. The right to deduct, therefore, does not arise by virtue of something in the declaration—it comes into effect on payment, and the shareholder cannot complain of its exercise. If a shareholder " refuses to allow " the deduction (whatever that may mean), he, like the recipient of interest under Rule 19 who makes a similar refusal, is liable to a penalty under General Rule 23 (1).

In the case of an unincorporated body of persons " making a " dividend of " its profits (to use the language of Section 54 of the Act of 1842 and Rule 20), Section 54 compelled the persons entitled to the profits to " allow out of " their dividends " a proportionate

(1) 18 T.C. 332.

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" deduction in respect of the duty so charged " in respect of the profits of the body of persons. Accordingly, if such a body made £1,000 profits and paid tax at 1*s*. in the £ thereon, and then proceeded to divide the balance among the persons entitled, they necessarily performed the operation of deduction by distributing the net sum. No declaration to that effect was needed—the mere payment of the net sum in cash was payment under deduction of tax.

In my opinion the essential character of the act of " deduction " has remained the same notwithstanding the fact that, under the law as it at present stands, the tax " deducted " from the dividend is not necessarily comparable with the tax paid, or to be paid, by the company in respect of the profits out of which the dividend is paid. It is indeed this latter circumstance which appears to give to the word " deduction " a concrete meaning which requires some specific act of deduction to be done. This appearance is accentuated by the provisions of Section 33 (1) of the Finance Act, 1924, which requires a company to show the gross and net amounts on the counterfoil of the dividend warrant, although I do not think that there is anything in that Sub-section which is inconsistent with the view which I have expressed as to the meaning of " deduction ".

Now if a company having a fund of profits in respect of which it has paid tax declares a dividend at a rate which exhausts the balance remaining after payment of the tax, and then proceeds to pay the dividend at the actual rate declared, it has " made a " dividend " of its net profits, and in doing so has (as it appears to me) of necessity " deducted " tax, at any rate where there is no difference in the rate of tax. Similarly, if the dividend does not exhaust the balance, the company will in my opinion have merely paid a " tax free " dividend. In each case the dividend would have to be accompanied by the statement required by Section 33 (1) of the Act of 1924, and would have to be " grossed " up " for Sur-tax purposes under Section 7 (2) of the Act of 1931. The amount received by the shareholder would, in my opinion, be a " net amount " within the meaning of both provisions, for it has been paid out of the net balance of a fund of profits which has borne tax, and the aggregate of the dividends actually paid is, in fact, less than the gross fund before tax was paid out of it by at least the amount of tax paid in respect of those profits.

The next case to be considered is where the tax falls to be deducted from the dividend at a rate higher than that in force when the profits out of which the dividend is paid were made. An example will make the point clear. Suppose a company makes £1,000 profit on which it pays tax at 4*s*. in the £, leaving £800. In a subsequent year, when the rate of tax is 5*s*. in the £, it declares a dividend at a rate which will exhaust £600 and then proceeds

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to distribute the whole of the £600 without deducting any sum in respect of tax. It appears to me that in such a case it has, in law, paid a "tax free" dividend, and that no language in the declaration can alter this fact. For the £600 plus tax (which at 5*s*. would amount to £200) would be no more than the actual net fund available for distribution, and it would not be possible to say, as was said in *Neumann's* case(1), that the operation of "grossing up" would involve assuming the existence of a sum which never in fact existed. In other words, the amount received by the taxpayer would be of necessity a net sum, and no express or implied intention to deduct would be required to make it such; nor could any declaration of intention not to deduct make it anything other than a net sum.

In a case falling under the second alternative in Sub-section (1) of Section 7 of the Act of 1931 the position is more complicated, since that alternative deals with the case where dividends are paid (as in the present instance) out of profits which will only come into computation in a year subsequent to that in which the dividend is paid. In such a case the profits have not borne tax, and there is nothing in law to prevent the company distributing the whole of them without deduction. I must confess that the case of such a distribution presents a difficulty, and it may be that it would be impossible to treat the dividend as a "net" dividend within the meaning of Sub-section (2). But that is not this case. Here the dividend declared and paid, plus an amount equal to tax at the standard rate, amounted to far less than the actual profits, and I see no difficulty in regarding the amount received by the shareholder as a net amount.

I have endeavoured to the best of my ability to construe the relevant provisions in the light of the decision in *Neumann's* case, and to confine that decision to the sole point which, in my judgment, it was intended to cover. If my reasoning is unsatisfactory my excuse must be that the whole system of deduction of tax from dividends is illogical from top to bottom, and any attempt to make it logical is necessarily open to criticism.

It only remains to say a word in reference to the cases of *Commissioners of Inland Revenue* v. *Pearson* and *Commissioners of Inland Revenue* v. *Pratt*, 20 T.C. 433; [1936] 2 K.B. 533, which were relied upon by Finlay, J., in his judgment in this case. In those cases dividends were paid out of accumulated profits, and the amount paid was the actual amount declared. The shareholders claimed that the sums received were gross amounts and ought not to be "grossed up" for Sur-tax purposes. The Special Commissioners took this view, but their decision was reversed by Lawrence, J. In my opinion those cases were correctly decided,

(1) 18 T.C. 332.

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although I am not sure that I quite agree with the whole of the reasoning of Lawrence, J. In the main, however, I do not think that his view differs from my own.

The appeal must be dismissed with costs.

Lord Romer (read by Sir Wilfrid Greene, M.R.).—I regret to find myself in disagreement with the other members of the Court.

In this case the Court has once more to consider the relative positions under the Income Tax Acts of a shareholder and his company in respect of the dividends that are paid to him from time to time.

Before the decision of the House of Lords in *Neumann's* case(1) there were some people, and I fear that I was one of them, who erroneously thought that the position of the shareholder was analogous to that of a debenture holder of the company in relation to the debenture interest. Being a legal entity entirely distinct from the entity of the company, it was thought that, in reference to the dividend, he was one taxpayer, and that, in reference to the profits of the company out of which the dividend was paid, the company was another and distinct taxpayer. If this had been the correct view, the shareholder would have been directly assessable to tax in respect of his dividends where the profits out of which they were paid were not brought into charge, the company only being entitled (although not bound), under Rule 20 of the General Rules applicable to All Schedules, to deduct the tax from the dividends when the latter were payable out of profits that had been brought into charge. In this respect only he would have differed from the debenture holder, the company being (under Rule 21) bound to deduct the tax from his interest when payable out of profits not brought into charge.

It was, however, held in *Neumann's* case that this is far from being the true position of the shareholder in relation to a dividend of a trading company. It was there held that the shareholder is never assessable in respect of the dividend, and that his true position is that which it had been stated to be by Lord Phillimore in *Bradbury* v. *English Sewing Cotton Co., Ltd.*, [1923] A.C. 744, at page 769(2). There, in reference to a company paying a dividend to its shareholders, he said this : " If the principle of its being a " distinct person, distinct from its shareholders . . . . , had been " carried to a logical conclusion, there would have been no reason " why each shareholder should not, in his turn, have to return as " part of his profits or gains under Sch. D, the money received by " him in dividends. Their taxation would seem to be logical, but " it would be destructive of joint stock company enterprise, so " the Act of 1842 has, apparently, proceeded on the idea that for " revenue purposes a joint stock company should be treated as a

(1) 18 T.C. 332. (2) 8 T.C. 481, at pp. 518/9.

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" large partnership, so that the payment of income tax by a com-
" pany would discharge the quasi-partners. The reason for their
" discharge may be the avoidance of double taxation, or to speak
" accurately, the avoidance of increased taxation. But the law is
" not founded upon the introduction of some equitable principle as
" modifying the statute; it is founded upon the provisions of the
" statute itself; and the statute carries the analogy of a partnership
" further, for it contemplates a company declaring a dividend on
" the gross gains, and then on the face of the dividend warrant
" making a proportionate deduction in respect of the duty, so that
" the shareholder whose total income is so small that he is exempt
" from income tax or pays at a lower rate, can get the income tax
" which has been deducted on the dividend warrant returned to
" him ".

Now the principle of treating the shareholder, for Revenue purposes, as if he were a partner with his co-shareholders, if carried to its logical conclusion, would render it improper for a company ever to deduct tax on paying a dividend, for if a partnership pays no tax on its profits, a partner's share cannot be diminished by deduction of tax. If, on the other hand, the partnership does pay Income Tax on its profits, all that can be distributed amongst the partners will be the net profits left after payment of the tax, and no further deduction for tax can be made, and this is true whether the whole or only a portion of the net profits are distributed. The principle would also lead to the logical conclusion that, for the purpose of " grossing up " a dividend for Sur-tax purposes, it would be necessary to ascertain what was the average rate of tax paid by the company on the whole of its profits that had been divided, and to "gross up" at the rate so ascertained. But the Legislature unfortunately thought it right, by Rule 20, to give a company an express power to deduct tax when paying dividends out of profits and gains " to be charged ". I say unfortunately, because the Rule, particularly in view of its later developments, has given rise to some difficulty. This is due to the fact that a company when distributing net profits by way of dividend does not in truth deduct tax from the dividends at all, even though it should purport so to do. For the deduction of tax has already been made when ascertaining the net profits. Should the company, therefore, purport to deduct tax from the dividends, the only result would be that it would distribute less of its net profits than it would do were no such deduction made. The sum deducted will be retained by the company and will be available for distribution as net profits in a subsequent year. A deduction of tax would no doubt be necessary if the company purported to be distributing by way of dividend the whole of its gross profits, but, in such a case, the so-called dividend of gross profits would not really be a dividend in the sense in which the word is used in Rule 20,

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for the company cannot properly distribute its gross profits among its shareholders. All that the company would in fact be doing, by going through the form of declaring the gross dividend and paying it less tax, would be to intimate to its shareholders, for Sur-tax and abatement purposes, what dividend they would have received had the gross profits been divided. The truth is that, when enacting Rule 20, the Legislature failed to bear in mind what has now been determined to be the true relative positions of a company and its shareholders for Revenue purposes, and gave power to a company to deduct tax from the net dividend as though it resembled, for tax purposes, interest on its debentures. The Rule, however, must be read as applying to a dividend regarded as a distribution amongst partners of the net profits of the concern, and, so read, it gives a company no power that it would not possess had the Rule never been enacted, for, obviously, a company can deduct tax from its gross profits before paying a dividend, the shareholders being entitled to nothing more than the net profits. Equally obviously a company can deduct the tax if it thinks fit to do so from the net profits, though the only effect of doing so will be, as I have already pointed out, to diminish the amount of net profits being distributed. The result would seem to be that, whenever a company declares a dividend of its gross profits, tax will, of course, be deducted, and the net dividend must be "grossed up" for Sur-tax purposes, and that, when the company declares a dividend of its net profits, the dividend must always be "grossed up" for Sur-tax purposes, whether the company does or does not purport to deduct the tax, unless the dividend is being paid out of profits that are not chargeable with tax at all.

I have so far treated the case on the footing that the only relevant statutory provisions are those to be found in the Act of 1918. But Section 39 of the Finance Act, 1927, provides that the deduction from a dividend which a company may make is a deduction of tax at the standard rate for the year in which the amount payable becomes due. This, again, seems to be inconsistent with the correct view of the relative position, for Revenue purposes, of the company and the receiver of the dividend, for the rate of tax deducted from the dividend may bear no relation to the rate of tax paid by the company. But even so the power to deduct is quite unnecessary, for the company is still unable to distribute more than its net profits left after deduction of the tax which it has paid, and a deduction of tax from net profits will again merely affect the amount of net profits being distributed. Whenever a dividend is paid out of net profits, by which I mean profits that have been taxed, a "grossing up" will still be necessary for Sur-tax and abatement purposes, whether the company does or does not purport to deduct tax. The Section in question will merely affect the rate at which the "grossing up" is done.

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I must now turn to Section 7 of the Finance Act, 1931. Sub-section (1) of that Section enables a company to deduct tax when distributing profits that have never been " brought into charge to " tax ", as that phrase was interpreted in the *Metropolitan Water Board* case, [1928] 1 K.B. 833(1). This was, therefore, an entirely new power conferred upon the company, and its exercise may have an important effect upon its shareholders. Before the Act was passed, if a company distributed profits that had not been brought into charge, no " grossing up " took place or ought to have taken place even if the company purported to deduct tax. The deduction merely reduced the amount of the profits divided. But since the Act, a distribution of untaxed profits, such as are mentioned in Sub-section (1), must, if paid under deduction of tax, be " grossed " up " for Sur-tax purposes. If not paid under deduction of tax they need not be " grossed up ". Such seems to be the effect of Sub-section (2) of Section 7, as interpreted in *Neumann's* case(2).

The position, therefore, seems to me to be as follows. If a company distributes, by way of dividend, profits that have been brought into charge to tax, the dividend must be " grossed up " for Sur-tax purposes, even though the company does not purport to deduct Income Tax. This is not (as has sometimes been thought to be the case(3)) because when there is no purported deduction of Income Tax the company is giving the shareholder, in addition to the dividend, something extra in the shape of a freedom from liability to tax, because the shareholder is never subject to any such liability. It is because the Income Tax on the profits has already been paid. *Commissioners of Inland Revenue* v. *Pearson* and *Commissioners of Inland Revenue* v. *Pratt*, [1936] 2 K.B. 533(4), were cases of this sort, and were, in my opinion, rightly decided, though I cannot agree with all the reasons given by Lawrence, J., for his decision. If, on the other hand, a company distributes, by way of dividend, profits and gains for a year which have not been charged to tax, but which, under the provisions of the Income Tax Acts, would fall to be included in computing the liability of the company to assessment to tax for that year if the computation had to be made by reference to such profits and gains, " grossing up " of the dividend for Sur-tax purposes will, in my opinion, be necessary only in cases where the company has, in fact, made a deduction for tax. In such a case " grossing " up " is made obligatory by Sub-section (2) of Section 7 of the Finance Act, 1931. But for that Section no " grossing up " could be required, for the dividend would be a share of profits that were not liable to be brought into charge, and could be properly distributed in full among the shareholders. The only question,

(1) Attorney-General *v.* Metropolitan Water Board, 13 T.C. 294. (2) 18 T.C. 332.
(3) *See* Attorney-General *v.* Ashton Gas Co., [1904] 2 Ch. 621, at p. 623.
(4) 20 T.C. 433.

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therefore, to be determined in the present case is whether the dividend falls within Section 7, Sub-section (2), for we are invited by the Crown to treat the case as though no part of the profits of the Company for the year ending 31st March, 1934, had been brought into charge to tax.

In my opinion it does not. The Company has made it quite clear that it has made no deduction for tax, it being expressly stated in the resolution for the dividend that it should be paid " without " deduction of Income Tax ". The amount received by the Appellant cannot, therefore, be regarded as being a net amount within the meaning of the Sub-section as interpreted in *Neumann's* case(1). For these reasons I respectfully differ from Finlay, J. He thought(2) that there was no difference between the expression " without deduction of tax " and " tax free ". In this I cannot agree with him. Lord Wright pointed out in *Neumann's* case, at page 373, that the phrase " tax free " indicates that the dividend is net and under deduction of tax. It is, therefore, the precise opposite of " without deduction of tax ".

It only remains to say a word or two about *Neumann's* case. The relative positions for Income Tax purposes of shareholders and their company being what they are there held to be, a real difficulty arises in a case, such as that was, of a company having profits taxable under Schedule A. Suppose such a company having £10,000 profits derived from house property of which the assessment value for Schedule A is £5,000. Income Tax being at the rate of 5*s*. in the £, the company will pay £1,250 in tax and can distribute £8,750 among its shareholders. If it does so without deduction of tax, the shareholders' income plainly can be " grossed up " to £10,000, that being the sum that under deduction of tax at 2*s*. 6*d*. in the £ will produce £8,750. If the company purports to pay under deduction of tax, as it has the power to do, the only effect will be that it will distribute a sum less than £8,750 by the amount of the tax deducted. Now suppose that for some reason the company distributes less than the £8,750—say, £4,375. Ought this to be " grossed up " to £5,625 by the addition of the £1,250 tax, or ought it only to be " grossed up " at 2*s*. 6*d*. in the £ to £5,000? In the latter case, the other £4,375 will also be " grossed up " to £5,000 after it is distributed. In the former case, the second £4,375, after it is distributed, will not be liable to be " grossed up " at all. It will have to be treated as a sum that is not taxable at all. Now this was, I suspect, the position of the £4,275 in *Neumann's* case. It was the sum remaining in the company's hands after the profits to the amount of the Schedule A assessment had been distributed. The persons to whom those profits had been distributed would, no doubt, have had them " grossed up " for Sur-tax purposes at the full rate of current Income Tax and not

(1) 18 T.C. 332. (2) *See* p. 611 *ante*.

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merely at the average rate of tax that the company was liable to pay in view of the *Salisbury House* decision(1). The £4,275 was, therefore, a sum which the shareholders were entitled to treat as a gross dividend, and so the House of Lords held. The company had not, in fact, made a deduction in that case. Had it done so the sum paid after deduction would still have remained a gross sum. The company would merely have failed to distribute the whole £4,275.

In my opinion the appeal should be allowed.

MacKinnon, L.J.—There is only one thing about this case of which I am certain, namely, that it presents perhaps the most difficult problem I have ever attempted to solve. That difficulty results from three factors : first, the extraordinary obscurity under the Income Tax Acts of the relative positions of a company and its shareholders as to the payment of Income Tax; secondly, the increase of that obscurity resulting from the introduction of Super-tax or Sur-tax; and, thirdly, the difficulty of ascertaining with certainty the effect of the case that is said to be most relevant, namely, the decision of the House of Lords in *Neumann's* case, 18 T.C. 332.

The most illuminating explanation of the historical origin of the first-mentioned obscurity I find in the utterance of Lord Phillimore in *Bradbury* v. *English Sewing Cotton Co., Ltd.*, 8 T.C. 481, at pages 518/9. It was read by Lord Tomlin in *Neumann's* case, at page 359, and I need not read it again. But though that may give the reason for the obscurity, it does not dissipate it, still less does it excuse it. In fact a company is a *persona* distinct from its shareholders, and they are not even *quasi* partners. In the attempt to grope their way through the region of make-believe thus created various acute minds have been led into error. For instance, Swinfen Eady, L.J., said : " where the duty is paid by a company " in respect of the gains and profits of its business it pays the " income tax as agent for its shareholders " (*Brooke* v. *Commissioners of Inland Revenue*, [1918] 1 K.B. 257, at page 267(2)). And Scrutton, L.J., in the same case, at page 270(3), said : " I am " quite clear that a company in paying income tax at the source " at any rate pays as agent of the shareholders ". But Viscount Cave in *Commissioners of Inland Revenue* v. *Blott*, [1921] 2 A.C. 171, at page 201(4), says : " Plainly, a company paying " income tax on its profits does not pay it as agent for its share-" holders ", and as the noble Viscount was delivering his opinion in the House of Lords, I must take it that Swinfen Eady, L.J., and Scrutton, L.J., were wrong.

(1) 15 T.C. 266. (2) 7 T.C. 261, at p. 273. (3) *Ibid.*, at p. 276.
(4) 8 T.C. 101, at p. 136.

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Entertaining, as I do, a lively expectation that I may be held to be wrong in this, or in any judgment, about Income Tax, I comfort myself in anticipation by the thought that I err in such distinguished company.

Whatever may be the true analysis of the position and relation of a company and its shareholders as to Income Tax, it seems to be clear that when the company has paid, or by a reserve has provided for, Income Tax on its profits, and distributed its net balance after such payment, or reserve, to the shareholders, each shareholder is not liable to be assessed to Income Tax on what he receives. His liability for tax at the standard rate has been discharged by what the company has done. But what the company has done has not discharged his liability for Sur-tax, if his total income exceeds the sum that attracts Sur-tax : nor has it imposed Income Tax upon him, if his total income is within the exemption from tax. In the former case he must include a sum in respect of the dividend in his return for Sur-tax : in the latter case he can, by making the proper claim, recover the tax notionally paid by him through the action of the company.

In the present case the Commissioners appear to have decided in favour of Mr. Cull on the ground that the description "without "deduction of tax" has not the same meaning as "tax free", and in the argument before us great reliance was put upon the taste or skill of the directors in the choice of adjectival expressions. I cannot think that the liability of a shareholder for Sur-tax can depend upon such qualities in the directors. It must depend upon the true nature of the sum of money received by the shareholder, and upon what the directors have done before they paid it to him; it cannot depend upon what they say to him when they pay it.

In the ordinary case a company which has paid, or made provision for paying, Income Tax on its profits, and distributes some, or all, of the balance to its shareholders, does so by sending a cheque for £*n* to a shareholder, with an accompanying voucher— "Dividend £*g*, *less* Income Tax £*t*, net amount £*n*". The shareholder who is within the class privileged to pay Sur-tax has to include £*g* in his return. The shareholder who is fortunate enough to have a very small income can claim to be paid £*t* by the authorities.

In the less ordinary case a company which has paid, or made provision for paying, tax on its profits, employs a different phraseology in distributing some, or all, of the balance among its shareholders. It does not say: "Dividend £*g*, *less* tax £*t*, net "amount £*n*"—it states the dividend as "£*n* free of Income "Tax". But of course the variation from the other form is a mere matter of words, not of substance. If a company has issued "Six per cent. preference shares free of Income Tax", it will, on a £100 holding, send out a warrant in the form, "Dividend £6

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"free of Income Tax", and attach a cheque for £6. If Income Tax were perpetually at 5*s*. in the £ (which Heaven forbid!), these shares might just as well be called "Eight per cent. "preference shares", and the dividend warrant would then be in the form, "Dividend £8, less tax £2, net amount £6". If it were in that more familiar form, the shareholder liable to Sur-tax would have to include £8 (*g*) in his return. If it was in the form "£6 free of Income Tax" (*n*), the shareholder was at one time put to a little more trouble, because he had to go through the calculation required to result in the figure £8 (*g*). But in obedience to Section 33 of the Finance Act, 1924, the company now saves him that trouble, usually, I think, by printing on the back of its voucher the £*g* amount relative to the £*n* shown on its face as the sum paid "free of tax". In such a case the matter becomes hardly even a matter of words, but merely of the parts of the paper on which they appear. Instead of putting on the face "£*g*, *less* £*t*, "*i.e.*, £*n*, payable", it puts on the face "£*n* amount payable", and on the back "£*g* is the result if £*t* be added to £*n*".

Though all this is elementary, it seems to me to illustrate that, as a matter of substance and not of phraseology, if a company which has paid, or has made provision for paying, tax on its profits, distributes a dividend to its shareholders which is stated to be £*n* (that is, the amount for which the cheque is filled up), the result is the same whether the dividend of £*n* is described as "free of "tax" or "without deduction of tax", or "actual", or by any other form of words, or with no words of description being added at all. The substance of the matter is that the shareholder is being paid a piece of income on which he is not liable to be directly assessed to Income Tax. In the normal case that is not because the sum in question is a sum which does not attract Income Tax, but because his tax upon it is deemed in some way to have been paid by what has been done by the company. If, therefore, the sum he receives, £*n*, is a sum on which notionally he has paid £*t* as tax, he must add £*t* to £*n*, and include the resulting £*g* in his Sur-tax return.

I say "in the normal case". *Gimson* v. *Inland Revenue Commissioners*, [1930] 2 K.B. 246(1), was an abnormal case. The shareholder there received from the company £*x*, which was called a dividend. But it was not a payment to the *quasi* partner of a share of profits of the *quasi* partnership on which Income Tax had been paid, or would have to be paid, by the company. In the mysterious language of Rule 20 of the General Rules, it was not any dividend of the "profits or gains to be charged on any body "of persons", and in paying it "the body of persons" would not be "entitled to deduct the tax appropriate thereto". For the money, of which £*x* was paid to Gimson as his share or dividend,

(1) 15 T.C. 595.

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was a sum made up from two sources, (*a*) from capital moneys, and (*b*) from profits of the company that were not liable to tax. Gimson was not liable to be directly assessed to tax on the £x he received. But that immunity arose, not because tax upon it had been notionally paid by what the company had done, but because it was money on which neither the company nor the shareholder was, having regard to its nature, liable to pay tax. And as Sur-tax is only payable upon items of income on which the subject has in fact, or notionally, paid, or is liable to pay, Income Tax, Gimson was not called upon to include the £x in his return for Sur-tax, after " grossing it up "—to use that lamentable verb which the curse of Sur-tax has imposed upon the English language.

In the present case the £21,000 received by Cull from the Company clearly did not possess one aspect of the abnormality of the sum received by Gimson in his case. Cull received a share not of any capital sum, but of the trading profits of the Company. Then can it be said that what he received was a share of profits of the Company that were not liable to Income Tax?

The Case finds that the Company's net profits for the year ending 31st March, 1934, were £559,374, and it was a part of these net profits that brought Cull his £21,000. The Case further finds that " owing to previous losses the Company was not liable to be " charged to Income Tax for the year ending the 5th April, 1934," but that the balance of £559,374 was arrived at after putting to reserve £99,114 as " a reserve for Income Tax which would become " chargeable in respect of the next financial year which would be " assessed on the basis of the Company's profits for the year to " the 31st March, 1934 ". That means that when the Company paid Cull £21,000, as part of its net balance of trading profits of £559,374, it had not yet paid Income Tax on the £559,374. But it would in due time be liable to pay it; £99,114 had been set aside in order to pay it; and the net figure of £559,374 had been arrived at after making that reserve. In order that a shareholder may be immune from assessment to Income Tax on a dividend he receives, by virtue of his tax having been notionally paid by what the company has done, it is not necessary that the company shall in fact have paid the tax before it pays him the dividend. It is obviously enough if the company is liable to pay it, and is going to pay it in due course. If I remember aright, this is reflected in the terms of the voucher attached to every ordinary warrant, by which a secretary certifies that the tax will be paid to the proper officer, not that it has been paid.

There remains one further fact. The Company paid Cull £21,000 on 31st March, 1934, that is, during the financial year ending 5th April, 1934. It was only liable to pay the Income Tax on the £559,374 in the financial year ending 5th April, 1935. Does that make any difference? Though strange things result from the

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Income Tax legislation, it would be very strange if Cull should not be liable for Sur-tax on £7,000 in respect of a payment to him on one day, but would be so liable in respect of the identical payment if it had been made a week later. I do not think it does make any difference. And I have at times had a glimmering of an idea that Section 7, Sub-section (1), of the Act of 1931 says that it shall not make any difference. But having read that Sub-section over and over again, I still am in doubt whether it has yet conveyed any meaning at all to my mind. It is a single sentence containing 138 words. I believe the Library of the British Museum could be searched in vain for the discovery of a sentence to outdo it in obscurity.

The Case further states that the first contention on behalf of Cull was that the £21,000 " was not a ' tax free ' dividend but a " dividend of twenty-one shillings per share from which the " Company was entitled but not bound to deduct Income Tax ". If the Company was so entitled, it must be because, in the language of Rule 20, it was a " body of persons " paying a dividend out of " profits or gains . . . . charged " [with Income Tax] " before " any dividend thereof is made ". That must also mean that, if the directors had been so minded, they might have declared this dividend in the form, " Dividend of 28*s*. per share, *less* 7*s*. Income " Tax, net dividend 21*s*." ; in which case Cull clearly must have included the 28*s*. figure in his Sur-tax return. Or they might have declared the dividend in the form, " Dividend 21*s*. free of tax " ; in which case again Cull must have put down the 28*s*. figure in his Sur-tax return. But it is said that because they adopt the form, " Dividend 21*s*. without deduction of Income Tax ", Cull need only put down the 21*s*. figure. The decision of the Special Commissioners accepted this, and therefore seems to have been based solely on this variation of language.

As I said before, I think it is impossible that a shareholder's liability for Sur-tax can depend upon the form of words in which directors of a company choose to characterise the dividend they pay to him. His liability must depend upon the essential nature of the payment. Looked at in that way, this was a payment of a dividend by way of a share of the profits of the Company, on which profits the Company was at the proper time liable to pay Income Tax. (By this time the Company has no doubt in fact paid it.) That being so, this dividend when received by Cull was not liable to assessment to tax in his hands. For it was in his hands income on which notionally he had paid tax, and a sum which notionally had by such payment been reduced from a larger sum. It follows, in my opinion, that he must include that larger sum in his Sur-tax return.

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It remains for me to consider whether this result is affected, or my opinion must be revised, by reason of the decision of the House of Lords in *Neumann* v. *Commissioners of Inland Revenue*, 18 T.C. 332, being the case principally relied on by the Appellant. That was, again, an abnormal case. The Salisbury House Co. put to reserve a sum of money to provide for additional Income Tax on their profits in case they should lose the suit *Salisbury House Estate, Ltd.* v. *Fry*(1). Having won that suit, they distributed the whole sum so set aside among their shareholders. Neumann, who was one of them, received £4,275. This was first described in an accompanying letter(2) as

" This dividend is equivalent to a gross " amount of	£5,343 15 0
" *Less* Income Tax at 4*s*. in the [£]	1,068 15 0
	" £4,275 0 0 ",

but in a subsequent communication the payment was described as a dividend of " 5% actual ", and the former account was amended to(3)

" Gross amount of dividend	£4,275 0 0
" Rate and amount of Income Tax " appropriate thereto	Nil.
" Net dividend	£4,275 0 0 ".

Neumann's case ensued upon the question whether he must include an item in respect of this dividend in his return for Sur-tax, and, if so, whether that item must be £4,275 or £5,343.

The House of Lords decided that an item in respect of this dividend must be included in his Sur-tax return. I understand this to be on the ground that the company, by paying their Income Tax under Schedule A, had discharged Neumann's liability for Income Tax on his dividend. If, therefore, his dividend was income on which he had had, in fact or notionally, to pay Income Tax, it was income that was liable to Sur-tax. If this be so, I confess I should personally have thought that what he received must be regarded as the net sum resulting from the notional deduction of tax from a larger amount, and that therefore he must put that larger amount into his Sur-tax return.

But their Lordships held that he need only insert £4,275, the sum he actually received, and not £5,343. The question is, what were the precise reasons for this part of their decision, and whether those reasons can avail the Appellant in this case to establish that he need only insert in his Sur-tax return the sum he received, £21,000, and not £28,000.

(1) 15 T.C. 266. (2) 18 T.C., at p. 335. (3) *Ibid.*, at p. 336.

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Of one thing I am quite sure. Their Lordships did not base their decision on the fact that the directors of the company had selected the adjective " actual ", or had used any particular language, in order to characterise the dividend they paid. It is clear that all such verbal experiments by a board of directors must be immaterial.

The reasons for this part of the judgment, which was on the Crown's cross-appeal, are in a small compass. Lord Tomlin dealt with it in one paragraph in 18 T.C., at page 364, and Lord Wright on pages 372 and 373. Lord Warrington merely expressed his concurrence with Lord Tomlin.

I am not sure that the reasoning of Lord Tomlin and of Lord Wright is exactly the same. Lord Tomlin appears to put it on the ground that the higher sum of £5,343 " not only has never " come to him " [Neumann] " but has never existed in fact ". Lord Wright, as his main reason, or in addition, lays emphasis on the word " net " in Section 7, Sub-section (2), of the Act of 1931. Lord Wright says[1]: " What was distributed—being " £4,275—was . . . . the gross amount; the company, though " authorised to deduct tax from it, was not bound to deduct it and " did not in fact do so. I cannot see any justification for describing " the sum distributed as a ' net amount ' and, hence, I conclude " that Section 7 (2) does not apply ".

I think Lord Wright is here referring to the same fact as Lord Tomlin, namely, that in the special circumstances of that case the company only had £4,275 which they could distribute to Neumann. If they deducted tax at all they could only have deducted it from £4,275, since that was all they had. They could not have deducted it from £5,343, since they had not got £5,343. Hence £4,275 could not be the " net " amount received. And hence Neumann could not be " deemed " to have received £5,343, since £5,343 never existed.

If that be the true basis of that decision, it depended on the very special facts of that case. But no such special facts exist in this case. The Company here distributed part of £559,374, which included £21,000 to Cull. But £559,374 was not all it had got. It had in addition £99,114 which it had set aside to meet the tax on the £559,374. As regards the £7,000 sought to be added to Cull's £21,000 for the purposes of his Sur-tax, that sum did not come to him, but it did exist in fact. It did not come to him because the company retained it, and in fact retained it as part of the reserve for Income Tax. And that being so, I see no difficulty in describing the £21,000 as the " net amount " received by Cull, and making Section 7, Sub-section (2), apply to it.

In the result I think this appeal must be dismissed with costs.

(1) 18 T.C., at pp. 373/4.

Sir Wilfrid Greene, M.R.—The appeal will be dismissed with costs.

Mr. Tucker.—May I ask your Lordships for leave to appeal in this case?

Sir Wilfrid Greene, M.R.—Yes.

Mr. Tucker.—If your Lordship pleases.

An appeal having been entered against the decision in the Court of Appeal, the case came before the House of Lords (Lords Atkin, Russell of Killowen, Macmillan, Wright and Porter) on the 15th, 16th, 19th, 20th and 22nd June, 1939, when judgment was reserved. On the 27th July, 1939, judgment was given unanimously against the Crown, with costs, reversing the decisions of the Courts below.

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

JUDGMENT

Lord Atkin (read by Lord Russell of Killowen).—My Lords, this is an appeal from the Court of Appeal, the Master of the Rolls and MacKinnon, L.J., Lord Romer dissenting, who affirmed a decision of Finlay, J., reversing upon a Case stated by the Commissioners for Special Purposes the determination of the Commissioners. The appeal to the Commissioners by the present Appellant was against an assessment to Sur-tax for the year ending 5th April, 1934, in the sum of £70,637. The question that arises is said, no doubt correctly, to be one of importance to the Revenue. It was fully debated at the hearing, but inasmuch as it appears to me to be completely covered by a recent decision of this House I find it unnecessary to deal with many of the topics of discussion.

The Appellant was the holder of 20,000 ordinary shares in Cull & Co., an unlimited company having a share capital of £800,000 divided into 700,000 preference and 100,000 ordinary shares of £1, all issued and fully paid. The company carries on business as bankers and financiers. On 13th March, 1934, the directors resolved " that the dividends on the 5% Cumulative " Preference shares for the four years to 31st March, 1934, be paid " on the 31st March, 1934, and that an interim dividend for the " year to 31st March, 1934, on the Ordinary shares of twenty-one " shillings per share be paid on 31st March, 1934, without deduction " of Income Tax ". In making his return of total income for Sur-tax purposes the Appellant included the sum of £21,000, his dividend on his holding of ordinary shares. The assessing Commissioners added £7,000 as representing Income Tax in respect of this dividend, thus increasing the assessment to £28,000. On

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appeal, the Commissioners for Special Purposes reduced the assessment by the sum of £7,000; and it was this determination which was reversed by Finlay, J., and gives rise to the present appeal.

My Lords, it is now clearly established that in the case of a limited company the company itself is chargeable to tax on its profits, and that it pays tax in discharge of its own liability and not as agent for its shareholders. The latter are not chargeable with Income Tax on dividends, and they are not assessed in respect of them. The reason presumably is that the amount which is available to be distributed as dividend has already been diminished by tax on the company, and that it is thought inequitable to charge it again. At one time it was thought that the company, in paying tax, paid on behalf of the shareholder: but this theory is now exploded by decisions in this House, and the position of the shareholders as to tax is as I have stated it.

The company may, however, in declaring a dividend, declare that it shall be paid tax free. Such a declaration is equivalent to giving the shareholder the right to such a sum as after making the deduction of the appropriate amount attributed to tax will produce the net tax-free dividend in fact paid. Such larger sum in truth represents the profit to which the shareholder has become entitled from the company, and is properly returnable in his total income for Sur-tax purposes—just as the gross income from which deductions of the appropriate sum for tax has in fact been made on payment is true income and is duly returnable. The right of the company to make a deduction, which is not in fact tax, for it represents a sum which is neither chargeable on the shareholder nor payable by the company to the Inland Revenue, is given now by Rule 20 of the General Rules applicable to all Schedules of the Income Tax Act, 1918. That Rule is as follows: "The profits "or gains to be charged on any body of persons shall be computed "in accordance with the provisions of this Act on the full amount "of the same before any dividend thereof is made in respect of "any share, right or title thereto, and the body of persons paying "such dividend shall be entitled to deduct the tax appropriate "thereto". The deduction is optional, and when it is made, the result in the instances I have given—a dividend which is paid less the deduction, and a dividend which is declared to be tax-free—is that the shareholder has suffered a deduction authorised by Statute from a total sum which otherwise he would be entitled to receive in full. In 1927 Sur-tax was substituted for Super-tax, and one of the provisions made for arriving at the total income for purposes of Sur-tax is contained in Section 39 (2), Finance Act, 1927: "In estimating under the Income Tax Acts the total "income of any person, any income which is chargeable with "income tax by way of deduction at the standard rate in force for

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" any year shall be deemed to be income of that year . . . .". That provision was not apt to cover the case of the deduction which a company is authorised under Rule 20 to make when paying a dividend, for, as I have said, the dividend is not in fact chargeable with tax.

No doubt to avoid this, amongst other difficulties, the Finance Act, 1931, contained the section, 7 (2), upon which this case depends: " (2) Subject as hereinafter provided, a dividend paid " by a body of persons, whether before or after the commencement " of this Act, shall, to the extent to which it is paid out of such " profits and gains as are mentioned in subsection (1) of this " section, be deemed, for all the purposes of the Income Tax Acts, " to represent income of such an amount as would, after such " deduction of tax as is authorised by the provisions of the said " Rule 20, be equal to the net amount received ".

The Crown contended that this Sub-section on its true construction applied to all cases where a deduction was authorized to be made and was not confined to those in which a deduction had actually been made. In their submission therefore, for the purposes of Income Tax, it imputed to the person receiving a payment from which no deduction had in fact been made the receipt of a hypothetical sum calculated as though deduction had been made—what is now known in Income Tax slang as "grossing up". Whatever might have been said for this construction before 1934, it is impossible now to accept it, for by the decision of this House in *Neumann* v. *Commissioners of Inland Revenue*, [1934] A.C. 215([1]), it was expressly held to be wrong. In that case the Salisbury House Estate, Ltd. had been assessed to Income Tax upon the whole of its receipts from rents which happened to exceed the Schedule A assessment to which it had been assessed and paid tax. In the case of *Fry* v. *Salisbury House Estate, Ltd.*, [1930] A.C. 432([2]), it was decided that the company was not assessable on receipts in excess of the Schedule A valuation. On the question being raised between the company and the Inland Revenue, the company had placed to Income Tax reserve a sum equivalent to the amount of tax further demanded: and upon the case being decided in their favour they then distributed amongst the shareholders without any deduction the total sum as placed to reserve. In *Neumann's* case the appellant was one of those shareholders. Originally the company had declared the dividend as being free of tax, and had sent the shareholder a cheque for £4,275 stating that it was equivalent to a gross amount of £5,343 15*s*. 0*d*. The appellant had therefore returned the larger sum as part of his total income. Later, the company withdrew and stated that they had erroneously described the dividend as tax-free. Thereupon the appellant

([1]) 18 T.C. 332. ([2]) 15 T.C. 266.

(Lord Atkin.)

claimed to reduce his total income return, alleging that neither the smaller nor the larger sum had to be included in his total income return, and appealed against his assessment. The Special Commissioners decided against him. On appeal Finlay, J., decided in his favour, holding that the sum was not paid out of profits brought into charge. The Court of Appeal decided against him. On appeal to this House it was held that the smaller sum had to be returned on the ground that it had been paid out of profits and gains brought into charge, but as to the larger sum it was held that Section 7 (2) did not apply. All the learned Lords held that that Sub-section did not operate unless there had been a deduction in fact. They were impressed with the apparent anomaly arising in the case before them from the fact that the whole sum divisible amongst the shareholders and distributed by the dividend in question was in fact paid to the shareholders, so that if there had been a " grossing up " of the dividend the shareholder would have had imputed to him an income to which he had not and never could have become entitled. Seeing that the contention of the Crown led to this result, the House came to the conclusion that the Sub-section had not the wide meaning imputed to it. Each of the learned Lords construed the Sub-section in its general application, and each of them came to the conclusion that it had no application to a case where in fact no deduction had been made. The language used appears to me to be quite free from any ambiguity or qualification.

Lord Tomlin said(1): " If a deduction from the gross sum was " authorized but was not in fact made, as was the case here, there " is in my opinion nothing in the language of the sub-section " which entitles the Inland Revenue to treat the gross sum as being " greater than in fact it was ".

Lord Warrington said(2): " I agree with my noble and learned " friend. In such a case as this, namely, where no deduction " is in fact made, there is no distinction between a gross sum and " a net sum. The actual sum paid, and not some wholly fictitious " sum, is therefore that which should be included in the return " of income ".

Lord Wright said(3): " I think the claim of the Respondents " fails because it ignores the word ' net ' in sub-section (2). That " word involves the idea of deduction, which in this case must be " a deduction of tax . . . . What was distributed, being £4,275, " was in my judgment the gross amount: the Company, though " authorized to deduct tax from it, was not bound to deduct it and " did not in fact do so. I cannot see any justification for describing " the sum distributed as a ' net amount ' and hence I conclude that " section 7, sub-section (2), does not apply ".

(1) 18 T.C. 332, at p. 364. (2) *Ibid.*, at p. 366. (3) *Ibid.*, at pp. 373/4.

(Lord Atkin.)

My Lords, I cannot think of words more apt to convey that the members of this House were putting a general construction on the words in question, and that in their view where no deduction was in fact made the Sub-section did not apply. The position where a " tax-free " dividend was declared was not within the purview of the decision. The construction so authoritatively stated binds us as it bound the Courts below. I find no justification for limiting it to facts precisely similar to those existing in that instance, or to cases where it might be supposed that no deduction could be made. Still more without warrant is it to put a limited construction upon the decision of the House because of the untoward results to the Revenue which may result. I decline to embark upon the consideration of the question whether the decision was right or wrong : it binds me, and I necessarily accept it. If it leads to ill results the effect can be remedied by legislation.

It follows from what I have said that the cases of *Commissioners of Inland Revenue* v. *Pearson* and *Commissioners of Inland Revenue* v. *Pratt*, [1936] 2 K.B. 533([1]), were wrongly decided and must be overruled. The appeal should be allowed, the Orders of the Court of Appeal and Finlay, J., should be set aside and the determination of the Commissioners for the Special Purposes of the Income Tax restored. The Appellant should have the costs here and in the Courts below.

Lord Russell of Killowen.—My Lords, I agree with the motion proposed. I do not restate the facts.

Our decision in this case depends, in my opinion, and depends solely, upon what is the proper construction to be placed upon Sub-section (2) of Section 7 of the Finance Act, 1931.

Rule 20 of the General Rules applicable to Schedules A, B, C, D, and E enables a company if it thinks fit, but does not compel it, before paying a dividend of its profits or gains " to be charged ", to deduct " the tax appropriate thereto ". The words " appro- " priate thereto " were subsequently made the subject of legislation by Section 39 of the Finance Act, 1927, which provided by Sub-section (1) that : " Such of the provisions of the Income Tax " Acts as provide . . . . that there may be deducted from any " dividend the tax appropriate thereto . . . shall have effect as " if they provided that tax may be deducted . . . . at the standard " rate for the year in which the amount payable becomes " due . . . ."

The 7th Section of the Finance Act, 1931, runs thus : " (1) The " provisions of Rule 20 of the General Rules, which authorise " the deduction of the appropriate tax from any dividend paid by " a body of persons, shall, in relation to a dividend paid by any

([1]) 20 T.C. 433.

(**Lord Russell of Killowen.**)

" body of persons, whether before or after the commencement of " this Act, be construed as authorising the deduction of tax from " the full amount paid out of profits and gains of the said body " which have been charged to tax or which, under the provisions " of the Income Tax Acts, would fall to be included in computing " the liability of the said body to assessment to tax for any year " if the said provisions required the computation to be made by " reference to the profits and gains of that year and not by reference " to those of any other year or period.

" (2) Subject as hereinafter provided, a dividend paid by a " body of persons, whether before or after the commencement of " this Act, shall, to the extent to which it is paid out of such " profits and gains as are mentioned in subsection (1) of this " section, be deemed, for all the purposes of the Income Tax " Acts, to represent income of such an amount as would, after " such deduction of tax as is authorised by the provisions of the " said Rule 20, be equal to the net amount received . . . ." The first Sub-section of this Section brought the dividend now in question within Rule 20, so as to enable the company if it thought fit to deduct tax; but it will be observed that while the amount which it could have deducted as the " tax appropriate thereto " has been definitely fixed at the standard rate for the year in which the amount of the dividend became due, it is in no way comparable with the tax payable by the company itself.

The second Sub-section is the crucial one in the present case, the sole question being, as I conceive, whether upon its true construction it does or does not apply to a dividend which is paid by a company without any deduction of tax having in fact been made by the company.

My Lords, in my opinion that very question was decided by this House in the case of *Neumann* v. *Commissioners of Inland Revenue*, [1934] A.C. 215(1), in which, as I read their opinions, all the noble Lords who took part in the debate expressed the view that the Sub-section only applied to cases where a company, after declaring a dividend of a stated amount, pays in satisfaction thereof a sum less than the stated amount of the dividend by a sum equal to tax thereon. In other words, that the Sub-section only applies to cases in which what the shareholder receives is a " net amount ", *i.e.*, an amount reduced from a larger amount by reason of a deduction made by the company against the shareholder.

Lord Tomlin can have meant nothing else when he said(2): " The sub-section in effect provides that it is the gross amount " before deduction which is to be treated as the income for the " purposes of the Acts. If a deduction from the gross sum was " authorized but was not in fact made, as was the case here,

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(1) 18 T.C. 332. (2) *Ibid.*, at p. 364.

(Lord Russell of Killowen.)

"there is in my opinion nothing in the language of the sub-section "which entitles the Inland Revenue to treat the gross sum as "being greater than in fact it was". Lord Warrington of Clyffe agreed with Lord Tomlin. "In such a case as this," he said(1), "namely where no deduction is in fact made, there is no distinction "between a gross sum and a net sum. The actual sum paid, and "not some wholly fictitious sum, is therefore that which should "be included in the return of income." Lord Wright is quite explicit on the point. What was distributed was in his opinion the gross amount; and he continues(2): "the Company, though "authorized to deduct tax from it, was not bound to deduct it and "did not in fact do so. I cannot see any justification for describing "the sum distributed as a 'net amount' and hence I conclude "that section 7 (2) does not apply. I cannot treat the word 'net' "as mere surplusage or as simply meaning the actual amount, "whether gross or net".

It was argued that the case was decided only upon its own special facts. I cannot assent to this view. It was a decision that the Section on its true construction did not apply if no deduction had in fact been made by the company before payment. Indeed, as I read the case, if the word "net" had not been in the Sub-section the decision must have been in favour of the Crown.

I agree with the result which was reached by Lord Romer, although there are some statements in his judgment with which I cannot concur. In particular I do not agree with the view that the cases of *Pratt* and *Pearson*(3) were rightly decided. But I do agree with the following passage which contains the grounds upon which he was prepared to allow the appeal, *viz.*(4): "The "only question, therefore, to be determined in the present case "is whether the dividend falls within Section 7, Sub-"section (2) . . . . In my opinion it does not. The Company "has made it quite clear that it has made no deduction for tax, "it being expressly stated in the resolution for the dividend that "it should be paid 'without deduction of Income Tax'. The "amount received by the Appellant cannot, therefore, be regarded "as being a net amount within the meaning of the Sub-section as "interpreted in *Neumann's* case(5). For these reasons I respectfully "differ from Finlay, J. He thought(6) that there was no difference "between the expression 'without deduction of tax' and 'tax "'free'. In this I cannot agree with him . . . . It is . . . . the "precise opposite of 'without deduction of tax'".

My Lords, for the reasons which I have given I would allow this appeal and restore the reduction of the assessment which was made by the Special Commissioners.

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(1) 18 T.C. 332 at p. 366. (2) *Ibid.*, at pp. 373/4. (3) 20 T.C. 433.
(4) *See* pp. 626/7 *ante*. (5) 18 T.C. 332. (6) *See* p. 611, *ante*.

Lord Macmillan.—My Lords, it is now well settled that the shareholders of a company are not liable to be directly charged with Income Tax at the standard rate on the dividends which they receive from the company. It is also settled that dividends received by any individual must be brought into computation in ascertaining his total income for Sur-tax purposes; they are a source of income within the meaning of Section 4 of the Income Tax Act, 1918. So far as Income Tax at the standard rate is concerned, dividends received by the shareholders of a company are regarded as franked by the payment by the company of Income Tax on its profits or gains. But companies are not liable to and do not pay Sur-tax, which is levied only on individuals. Consequently, dividends received by shareholders of a company are not franked, so far as regards Sur-tax, by any payment of Sur-tax by the company.

The present appeal relates to the question of the proper way of treating dividends in the individual taxpayer's return of his total income from all sources for the purpose of ascertaining his liability to Sur-tax.

In making a return of his total income the taxpayer has to classify the items of his income under two main heads, *viz.*, (1) income not taxed at the source, and (2) income taxed at the source. Income which has been received by the taxpayer without any deduction in respect of Income Tax is entered at the actual amount received as income not taxed at the source; income which has been received less a deduction in respect of tax is income taxed at the source and must be entered at the gross amount before deduction of tax, for Income Tax paid or suffered is not a permissible deduction in computing total income.

A company, on paying dividends to its shareholders, is entitled but not bound to deduct Income Tax at the standard rate at the time of payment. If the company exercises this right and deducts the tax from the dividends which it pays, the shareholders must, on entering the dividends in their return of total income, add back the deducted tax to the net amount actually received. But what if the company does not exercise its right of deduction and chooses to pay its dividends without deduction of tax? Ought the shareholder (1) to enter the actual sum received by him as income not taxed at the source, or ought he (2) to enter such a sum as, after deduction of tax, would give the sum actually received, thus treating the dividends as income taxed at the source? That is the question which the present appeal poses.

Apart from the terms of Section 7 (2) of the Finance Act, 1931, I cannot see any justification for the second of these alternatives. The dividend has been received by the shareholder without deduction of tax. Why should he add back tax which has not been deducted? Why should he treat as income taxed at the source income

(Lord Macmillan.)

which has not been taxed at the source? But it is said that Section 7 (2) of the Act of 1931 requires this to be done, and regards every dividend received, whether tax has or has not been deducted from it, as a " net amount received ".

In my opinion, this contention cannot be entertained by your Lordships in view of the decision of this House in *Neumann* v. *Commissioners of Inland Revenue*, [1934] A.C. 215([1]). I do not read that decision as turning on the special facts of the case. It is an authoritative interpretation of the meaning and effect of Section 7 (2) of the 1931 Act and it gives no countenance to the argument which has been advanced on behalf of the Inland Revenue at your Lordships' bar and which commended itself to the majority of the learned Lords Justices in the Court of Appeal. I do not feel called upon either to criticise or to justify the decision in *Neumann's* case, but I may at least say that it is consonant with the general scheme of computing income for tax purposes which I have outlined. One conception which found favour with the learned Master of the Rolls, I find myself, with the greatest respect, unable to accept as applicable to the interpretation of the critical Sub-section. He suggests([2]) that a shareholder who receives a dividend from which the company has not deducted tax may, in some cases at least, be said to receive a " net amount " because he is receiving payment from a company which has already paid Income Tax on the fund out of which the dividend is paid. But the tax which the company pays on its profits and gains need not be the same either in rate or in total amount as the tax which it refrains from deducting in paying dividends to its shareholders without deduction of tax. The company has not suffered deduction of Income Tax from its profits or gains; it has paid Income Tax on its profits or gains. The divisible fund is diminished by that payment, no doubt, but this cannot properly be described as a deduction of tax at the source of the shareholder's dividend. The question of deduction or no deduction arises only when the company proceeds to distribute its dividends. I do not think that the word " net " in the Sub-section can be read as equally applicable to the amount which the shareholder receives whether the company does or does not deduct tax. So to hold would be to treat the same word as having two quite different meanings.

The case of the so-called tax-free dividend does not arise, but as it has been discussed both in this House and in the Court of Appeal, I may point out that such a form of dividend is unknown to the Income Tax code, which knows only dividends from which tax has been deducted at the source and dividends from which tax has not been deducted at the source. The expression has, however, been judicially interpreted to mean a dividend of such a

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([1]) 18 T.C. 332. ([2]) *See* p. 621 *ante*.

(Lord Macmillan.)

sum as after deduction of tax gives the actual sum received. The tax-free dividend is not really a dividend of the amount received, but a dividend of a larger sum less the tax thereon. It is therefore treated notionally as income taxed at the source and in the return of total income must be entered at the gross amount which, less tax, gives the actual net amount received.

With these few observations, I concur with your Lordships in holding that the appeal should be allowed.

Lord Wright.—My Lords, the question in this appeal is: what is the effect of the judgment of this House in *Neumann* v. *Commissioners of Inland Revenue*, [1934] A.C. 215(1)? It was sought on behalf of the Respondents to distinguish that decision on the ground that it did not lay down any general rule for the construction of Section 7 (2) of the Finance Act, 1931, but was limited to the special facts of that case and should not be applied to the facts of this case. Such was, in substance, the contention before your Lordships of the Attorney-General, which succeeded before Finlay, J., and the majority of the Court of Appeal, consisting of the Master of the Rolls and MacKinnon, L.J. Lord Romer, in dissenting, agreed with the conclusion of the Commissioners for the Special Purposes of the Income Tax Acts.

The question can be shortly stated to be whether a dividend of £21,000 declared by Cull & Co., "without deduction of Income "Tax", could be treated for Sur-tax purposes as though it had been a dividend of £28,000 from which the company had deducted standard Income Tax of £7,000. The question may be stated in other words as being whether the sum of £21,000 was a net sum which under Section 7 (2) was to be deemed to represent income of such an amount as would, after such deduction of tax as is authorised by the provisions of Rule 20 of the General Rules, be equal to the net amount received. The contention on behalf of the Appellant was that the decision in *Neumann* was general and was that the Sub-section, on its true construction, did not apply unless there was in fact such an amount received as could properly be called a "net" amount, the word "net" being there used in the same sense as in Section 33 of the Finance Act, 1924. That Section requires that a dividend warrant should be accompanied by a statement in writing showing (1) the gross amount which, after deduction of the Income Tax appropriate thereto, corresponds to the net amount actually paid, (2) the rate and amount of such tax, and (3) the net amount actually paid. This can apply only to cases where the deduction has been made, because under Rule 20 the deduction is optional, not obligatory, and hence if the company in paying the dividend does not choose to deduct the tax, the dividend so paid without deduction of tax cannot be a net

(1) 18 T.C. 332.

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amount, but must be a gross amount; and hence it was contended a dividend so paid without deduction of tax is, in substance and not merely in words, a different matter from a dividend paid after deduction of tax or tax-free, both of which expressions have the same meaning. For instance, if standard Income Tax were payable by the Appellant on his dividend of £21,000, it would be in this case on a sum of £21,000, whereas if £21,000 had been paid tax free or after deduction of tax the gross sum, applying the computation just stated, would be £28,000. This instance shows clearly the different effect of declaring a dividend tax free and declaring a dividend without deduction of tax. In the former event the tax-free dividend does not represent income on which the standard tax is to be charged, but such a sum of net income as would, if standard Income Tax were chargeable, leave a net sum of £21,000, the tax being, say, £7,000. On the other hand, an income of £21,000 without deduction of tax would only pay, at 5*s*. in the £, a tax of £5,250.

As I have come to the conclusion, after a careful consideration of the reports in *Neumann's* case(1), that this House did give a decision on the general construction of the Sub-section and not a decision limited to the special facts of that case, it only here remains to decide if good reason is shown why the general construction of the Sub-section declared by this House should not be applied in the present case. It is not competent for your Lordships to reopen a previous decision of this House on a point of law, even if, on reconsideration, it should appear to be erroneous, which I am far from thinking could be said of the decision in *Neumann*. Nor is it open to the Court of Appeal or to a Judge of first instance to go behind the decision. A judgment of the House on an issue of law, whether unanimous or by a majority, is different from a mere expression of opinion or matter of observation not necessary for the case. It fixes the law, which can then only be changed by Parliament. All I intend, therefore, to do in this opinion is to explain briefly what was actually decided, and to examine the grounds which are relied on for the contentions that the decision was one limited to special facts, and that the actual facts of the present case are distinguishable and necessitate a different conclusion. I shall therefore state first in summary form what I understand to have been the facts in *Neumann*, and the ruling of this House on the construction of the Sub-section.

In *Neumann* the Salisbury House Estate, Ltd. had declared a dividend in favour of Neumann, a shareholder, in the form: "Gross amount of dividend £4,275, Rate and amount of Income "Tax appropriate thereto, Nil, £4,275"(2). This dividend represented Neumann's share of a sum of £18,325, which the company

(1) 18 T.C. 332. (2) *Ibid.*, at p. 336.

(Lord Wright.)

had set aside to reserve out of profits to await the decision in the case of *Fry* v. *Salisbury House Estate, Ltd.*, [1930] A.C. 432(1). The company owned flats, and was taxed under Schedule A; but the Schedule A assessment came to much less than the actual rents collected. It was held by this House in *Fry's* case that the Schedule A assessment exhausted the taxable capacity of the rents and that no further assessment to standard Income Tax was competent under Schedule D in respect of the amount by which the rents exceeded the Schedule A assessment. The company thereupon distributed in full to the shareholders the reserve fund of £18,325 as an interim dividend. The question then arose as to the position of Neumann as a shareholder. There were two questions, first whether he was assessable to Sur-tax at all on the £4,275, and, secondly, if he were, whether he was assessable at £4,275, or £5,343 15*s*. This latter sum was the amount which would, after such deduction of tax as is authorised by Rule 20, have been equal to the net amount received. On the first point this House held that the dividend was not directly or separately assessable to Income Tax in the shareholder's hands, but was still chargeable to Sur-tax because it was Income Tax income which had been charged to tax. The assessment under Schedule A had charged exhaustively the whole of the rents, so that the company was entitled under Rule 20 to deduct the tax appropriate thereto from the £18,325 if it had been minded to do so—though it had not, but had distributed the gross amount. On the second point this House held that Section 7, Sub-section (2), of the Finance Act, 1931, did not apply because, on the true construction of the Sub-section, it only applied to a net amount, whereas the £4,275 received by Neumann was a gross and not a net amount. The three Lords of Appeal who took part in the decision were unanimous, and their opinions agreed in substance in all respects. It will be enough here to quote the following passage (at page 230(2)) from the speech of Lord Tomlin, who gave the leading opinion: "The sub-section in effect provides that it is the gross "amount before deduction which is to be treated as the income for "the purposes of the Acts. If a deduction from the gross sum was "authorized but was not in fact made, as was the case here, there "is in my opinion nothing in the language of the sub-section which "entitles the Inland Revenue to treat the gross sum as being "greater than in fact it was". Lord Warrington agreed(3). I may perhaps be permitted to quote from the speech which I delivered, a short passage at page 243(4): "What was distributed, "being £4,275, was in my judgment the gross amount: the "Company, though authorized to deduct tax from it, were not "bound to deduct it and did not in fact do so. I cannot see any

(1) 15 T.C. 266. (2) 18 T.C., at p. 364. (3) *Ibid.*, at p. 366.
(4) *Ibid.*, at p. 373.

(Lord Wright.)

"justification for describing the sum distributed as a 'net amount' "and hence I conclude that section 7, sub-section (2), does not "apply. I cannot treat the word 'net' as mere surplusage or as "simply meaning the actual amount, whether gross or net".

I must resist the temptation to develop the reasoning on which this conclusion was based. It is to be found in the report in Appeal Cases ([1934] A.C. 215). I may, however, add that Section 7, Sub-section (2), is dealing with a conventional "grossing up", as it is called, but when it comes to the amount received, that must necessarily be a fact. The Sub-section does not say that the amount received is to be deemed to be net whether or not in fact deduction has been made. If the purpose of the Act is to secure that the shareholder pays Sur-tax by "grossing up" whatever amount he receives in fact, whether the company has deducted tax or not, they could effect this result by a simple change of language or by making it compulsory in every case for a company to deduct tax under Rule 20, and thus avoid payment of dividends without deduction of tax. It might seem that the framers of Section 7, Sub-section (2), had overlooked the optional terms of Rule 20. But I do not pursue the subject, as all that I am concerned at the moment to do is to point out that the decision in *Neumann*(1) was directly and expressly based on the construction of the language of the Sub-section. This House having in precise terms determined the construction, has fixed the law, which can only be changed by the Legislature.

I shall now examine in a little more detail the contention strongly urged on behalf of the Crown that the decision in *Neumann* was not based on the general construction of the Sub-section, but on the special facts of the case. I find it difficult to see how that contention can be seriously maintained in view of the precise language quoted above from the speeches of the Lords in which the crucial and decisive conclusion is finally stated. Now, it is true that the facts in *Neumann* were in some respects special. The directors were distributing £18,325 which had been specifically set aside as a reserve in case the company were held liable for the extra tax. In the event it was not required. The company might in paying the amount have deducted the tax when they distributed it, because it was paid out of charged profits. In that case they would have properly deducted the tax in *Neumann's* case from £4,275, not from £5,343 15*s*., because they were only distributing and paying £18,325 in all, of which £4,275 was Neumann's share. It is with this aspect in mind that Lord Tomlin (at page 230(2)) says: "Now I think it would be repellent to most "minds that the appellant should be charged as a part of his income "with a sum which not only has never come to him but has never

(1) 18 T.C. 332. (2) *Ibid.*, at p. 364.

(Lord Wright.)

" existed in fact. It is plain that the respondents' cross-appeal, " which seeks to treat the sum of £4,275 as a net sum, correspond- " ing to a gross sum of £5,343 15*s*., assumes that the amount " divisible by the Company was something in excess of anything " they ever had to divide ". Lord Warrington and I make similar observations. But it is clear on a perusal of the speeches that this matter was not the *ratio decidendi*. I said (at page 242[1]): " however anomalous the claim it must receive effect if the actual " language of the section so requires ". The final conclusion in all three speeches was based expressly on the actual language of the Sub-section. In every case, it is for the company to decide (subject no doubt to certain considerations of company law, and of policy) what sum they will set aside to declare and distribute by way of dividends. This becomes the divisible fund for this purpose. The company can also decide if the fund is to be distributed as gross or net. In *Neumann's* case it does not appear that the company had not adequate funds outside the £18,325, or that they might not, if so advised, have distributed £18,325 as a tax-free sum, or as a sum after deduction of Income Tax, in which case the nominal amount of distribution would be the larger or gross sum necessary to represent a net sum of £18,325 after deduction of the appropriate tax. There is nothing peculiar in the facts in *Neumann*, except the particular circumstances and reasons which led to the setting aside of the fund, and made it natural to divide it in full. Though notionally they had paid tax on it, they had not done so in a business sense. In the speeches in this House, this aspect was merely emphasised to point the moral that dividends declared without deduction of tax may exhaust a special fund set aside to meet them. The peculiarity in *Neumann* was that the fund set aside had borne the tax only in a notional and not in a business sense. But a company, in setting aside out of profits a sum for payment of dividends, can always, even if all the profits have been taxed in full, disregard that fact and decide not to deduct tax under Rule 20. If a declaration of dividend is made " without deduction of tax ", as it may be under Rule 20, and if " gross " and " net " mean what they mean in Section 33 of the Finance Act, 1924, the dividend is gross even though it is paid out of taxed profits, which in another sense may be called net, and there is no scope for " grossing up " (as it is called) what is already " gross ". That can only logically be done when the dividend is declared as a " net " dividend, that is, after deduction of tax or tax free. It can then properly be " grossed up " to the larger amount as specified in Section 7, Sub-section (2). It is true that the practice of declaring a gross dividend and then deducting the appropriate tax does not affect the sum which the shareholder receives. The same is true of a

(1) 18 T.C. 332, at p. 373.

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tax-free dividend, as it is also indeed of a dividend without deduction of tax. But owing to the language of the Acts it does affect the Sur-tax.

I can now pass to consider the case under appeal. The company in that case had made, in the year of assessment, large profits, which were not in that year liable to assessment. They did, however, set aside £99,114 as a reserve because these profits would be brought into computation and would attract tax in the following year. That left £559,374, which was carried on the balance sheet as a balance of net profit. It was the balance of profits and gains, though in fact it had paid no tax. Out of that sum various appropriations were made, in particular a sum of £105,000, to satisfy an interim dividend of 21*s*. a share to be declared " without " deduction of Income Tax ". The Appellant having been assessed to Sur-tax on the basis of a " gross " or " grossed up " dividend at the rate of 28*s*. a share, succeeded in his appeal to the Commissioners for Special Purposes who held as follows : " In the case " before us it is contended on behalf of the Crown that in the " resolution of 13th March, 1934, the words ' without deduction " ' of Income Tax ' should be read as ' after deduction of Income " ' Tax ', and that the dividend is a ' tax free ' dividend. In our " opinion the words ' without deduction of Income Tax ' qualify " the words ' be paid ' and mean that no deduction on account of " Income Tax is to be made on payment of the dividend of " 21*s*. per share. Accordingly, we hold that the dividend is not " a ' tax free ' dividend, that no Income Tax has been deducted " by the Company, and that no addition to the dividend should be " made on account of Income Tax. We, therefore, reduce the " assessment by the sum of £7,000 ".

In my opinion, the Commissioners correctly applied to the facts of the case the law laid down by this House in *Neumann*(1). I cannot see any distinction in the facts which is material to the question. The company's profits for the year were not assessable to Income Tax because there had been no profits of the trading in the previous year, but they would be chargeable in another year, that is, the following year, so that under Section 7, Sub-section (1), of the Finance Act, 1931, the company were authorised to deduct the tax, just as the directors might have deducted the tax if so minded in *Neumann's* case. The dividends were thus notionally charged to tax. It is not necessary or relevant to speculate why the directors did not deduct tax; it is enough that in fact they did not do so. Nor is it material that in this case the company had available profits of the year far in excess of the amount which they decided to distribute as dividend on the ordinary shares. The amount distributed in dividends may and generally will have no relation at all to the profits earned in the year. It may be taken in

(1) 18 T.C. 332.

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whole or in part from a reserve fund for the equalisation of dividends or from any profits which have been earned in previous years and charged at a rate of tax different from the rate current when the dividend is declared; it may be a small proportion of the profits earned in the year. It is this want of correlation between the dividends and the profits of the year which has led to the provision of Section 39 of the Finance Act, 1927, which (*inter alia*) provides that the deduction if made on account of Income Tax shall be at the standard rate of the year of declaration irrespective of the rate or rates at which the company paid tax on the profits, which may have accrued in other years. These are some of the circumstances which have led to the rule now well established and finally affirmed in *Neumann's* case[1] that the shareholder is not taxed under Schedule D in respect of that part of his income which consists of dividends. The profits have been charged to tax in the hands of the company and that fact is deemed to redound to his benefit. I have already explained why the special reason which induced the company in *Neumann's* case to set aside the special reserve does not affect the position any more than does the special reason which in any case influences a company in deciding what part of its profits it will set aside for paying dividends. The essential fact is that in this case as in *Neumann's* the company did not exercise its optional authority to deduct Income Tax, but paid without deduction.

It now becomes necessary to examine the reasons which induced Finlay, J., and the majority of the Court of Appeal to reverse the decision of the Special Commissioners. As Finlay, J., followed the decision of Lawrence, J., in *Commissioners of Inland Revenue* v. *Pearson*, and *Commissioners of Inland Revenue* v. *Pratt*, [1936] 2 K.B. 533[2], these cases must first be considered. The companies in these cases had not deducted tax in paying the dividends, though the dividends were paid out of profits charged to tax. It is not material that in the former case they were paid out of accumulated profits. The Special Commissioners in each of these cases held, as they did in this case, that the dividends paid were gross sums, and that Section 7, Sub-section (2) of the Finance Act, 1931, did not apply. The contention of the Attorney-General is summarised at page 536 in the following terms: "Where the company's profits "have been taxed, as here, and the company has power to deduct "tax from the shareholders' dividends, the sum paid is a net sum "to which must be added for purposes of sur-tax the amount of tax "appropriate to the profits distributed in dividend". I may note that the same might be said of the facts in *Neumann's* case. Lawrence, J., acceded to the contention of the Attorney-General, and reversed the decision of the Special Commissioners. He seems to have been influenced by the consideration that if the decision

(1) 18 T.C. 332. (2) 20 T.C. 433.

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of the Commissioners were right, any company could ensure that its shareholders should be taxable to Sur-tax only on the actual amount received in cash, by the simple process of declaring dividends without deduction of tax. That may be the result of the decision in *Neumann's* case(1), but it follows from the fact that the deduction of tax by a company in paying dividends is optional not obligatory. He seeks to distinguish(2) *Neumann's* case because in that case the tax was not charged " pound for pound " on the profits distributed under Schedule A, whereas in the cases before him it had been charged " pound for pound " under Schedule D, at some time or another on the company's profits. But that distinction is immaterial; all that is material under Rule 20 is that the profits should have, at some time or other, duly borne the appropriate tax, whatever it was. This was equally true in *Neumann's* case. Lawrence, J., also sought to distinguish *Neumann* because the dividends paid exhausted the specially segregated fund, whereas that was not so in the cases before him. I have commented on that point, which, in my opinion, is not a true basis of distinction. The Judge further held that the cases before him were governed by the *Ashton Gas Company's* case, [1906] A.C. 10, and not by *Neumann's* case at all. With the greatest respect for the learned Judge, I am bound to say that I do not think that the *Ashton Gas* case throws any light at all on the problems now being considered. It was an entirely different case. It was not a tax case at all. The company there was a statutory undertaking, the special Act of which provided that the profits divisible in any year divided among the ordinary shareholders should not exceed a given rate. The company declared and paid a dividend at the full permitted rate without deducting tax, and in doing so obviously divided more of their profits than they would have done if they had paid the profits after deducting Income Tax, and exceeded the divisible rate. Buckley, J. (as he then was), put the question thus ([1904] 2 Ch. 621, at page 625): " The whole " question is, Are the profits thus divided among the shareholders " in excess of 10 per cent. on the capital? I think they are. It is " exactly as if the company declared a dividend of 10 per cent., and " the amount of the income tax, so that when the statutory " deduction of the income tax is made the shareholder shall have " a clear 10 per cent.". This decision was affirmed by the Court of Appeal and the House of Lords. Lord Halsbury, L.C., said(3) it was perfectly clear: the question was simply whether the company was dividing more of its profits in paying the dividends than it was permitted to do. It was held in effect that, in arriving at the permitted rate of dividend, the profits ought to be calculated as inclusive and not exclusive of the amount payable for the year in respect of the Income Tax on the profits proposed to be divided.

(1) 18 T.C. 332. (2) 20 T.C. 433, at p. 443. (3) [1906] A.C. 10, at pp. 11/3.

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It cost the company more profits to pay 10 per cent. without deducting Income Tax than to pay 10 per cent. less Income Tax. When Lord Wrenbury in *Bradbury* v. *English Sewing Cotton Co. Ltd.*, [1923] A.C. 744, at page 766(1), concisely, though not with all necessary qualifications, expressed the now accepted view of the immunity of a shareholder in regard to Income Tax in the words " The corporator bore his share of the tax by the deduction " of the appropriate share of the collective tax paid by the corpora- " tion from his dividend ", he showed no consciousness that he was contradicting what he had said in the *Ashton Gas* case(2). I cannot see how that case throws any light on the true construction of Section 7, Sub-section (2), of the Finance Act, 1931. It was cited to this House in *Neumann's* case(3), but no member of the House thought fit to refer to it. I think that on such questions as have to be considered here, it should be disregarded once and for all. I observe that the *Ashton Gas Co.*(4) decision is not mentioned in any of the judgments in the Court of Appeal in the present case.

With all deference to the learned Judge, I cannot but think that the cases of *Pearson* and *Pratt*(5) were wrongly decided.

Finlay, J., followed the decision of Lawrence, J. He attached importance to the *Ashton Gas* case, and seemed to emphasise expressions to be found in that case to the effect that the shareholder who gets 10 per cent. on his share gets not merely £10 but an immunity from tax. That, I think, is inconsistent with the settled principle that a dividend is not directly assessable to tax on what the shareholder is paid. The actual amount which he is paid differs according as the company does or does not deduct tax in paying, but what is paid is in itself immune from standard tax in the shareholder's hands. He needs no added immunity. Finlay, J., also finds himself unable to draw a distinction between the words " free " of Income Tax " and the words " without deduction of tax ". But I venture to think that the distinction was clearly pointed out by the House of Lords in *Neumann* in the sense which I have explained above. I cannot, with respect, assent to the reasoning of Finlay, J., any more than to that of Lawrence, J., whose judgment he followed.

The judgment of Finlay, J., was affirmed by the Master of the Rolls and MacKinnon, L.J. The Master of the Rolls is impressed by the far-reaching results of the decision in *Neumann*, which he says the Legislature can scarcely have intended(6). I venture to repeat the comment on this contention which I made earlier in this opinion. The argument *ab inconvenienti* is no doubt of weight when the words of the Act are equally open to one or other of two

(1) 8 T.C. 481, at p. 516. (2) [1904] 2 Ch. 621, at pp. 623./5. (3) 18 T.C. 332.
(4) [1904] 2 Ch. 621, and [1906] A.C. 10. (5) 20 T.C. 433. (6) *See* p. 619 *ante*.

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constructions, but once the construction is settled, the argument becomes inadmissible. It is no doubt true that the purpose of the Legislature may have been to bring into Sur-tax by means of the shareholders' dividends the profits of the company which, in the hands of the company are not subject to Sur-tax, but the steps taken to achieve that result have been opportunist and lacking in a clear or comprehensive scheme. I am almost tempted to say that the draftsmen may have overlooked that a dividend might be not merely tax-free or under deduction of tax, but without deduction of tax, that is, might be either gross or net though in either case it is paid out of taxed profits of the company. If the consequences of the *Neumann*(1) decision are so serious it is for the Legislature to change the law. Nor can I agree with the view of the Master of the Rolls that the dividend is net whenever it is paid out of profits which have suffered payment of tax. This, I think, involves in another form the failure to distinguish between the company's profits and the tax on them on the one hand and on the other hand the dividend and the Sur-tax on it. A dividend paid out of net profits of the company (as it must generally be) can be either gross or net, according as it is paid tax free or without deduction of tax. In such latter cases the question is between the shareholder and the Revenue. The payment by the company of its Income Tax is a matter between the company and the Revenue. A dividend is not net because it is not independently chargeable to standard tax. Nor do I agree with the Master of the Rolls in his view that the language in *Neumann's* case was used with specific reference to the fact that to "gross up" the dividend in question would have involved the false assumption that the total fund of profits which the company had to distribute was greater than in fact it was. That fact, though naturally adverted to in the speeches in this House, was, as I have explained, in truth irrelevant to the general construction of the Sub-section. The Master of the Rolls further was of opinion that as, in the present case, the dividend paid amounted to far less than the total profits which the company had to distribute, there was no difficulty in regarding the amount received by the Appellant as a net amount. With the utmost respect, the matter seems to me to be irrelevant. I cannot, as I have explained, hold that it is in any sense material to the question at issue whether the company distributed the whole or a greater or less proportion of its available fund of profits. All that is material is whether the company declared the dividend as with or without deduction of tax. I think the word "deduct" or "deduction" is used both in Rule 20 and in the material Sections of the Finance Acts of 1927 and 1931 in its ordinary sense of a sum being declared, a sum taken away from it, and a smaller sum

(1) 18 T.C. 332.

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left to be paid. It is true that, in the result, the process only affects the Sur-tax payer. But if there is no deduction under Rule 20, there is a case in fact to which by its terms Section 7 (2) does not apply. The judgment of MacKinnon, L.J., does not differ in substance from that of the Master of the Rolls, and accordingly I need not repeat what I have already said as to the reasons why, with all deference, I feel constrained to take a different view. It will also be apparent from what I have already said that while I agree with the conclusion of my noble and learned friend, Lord Romer, there are certain matters on which I do not see eye to eye with him.

I think the appeal should be allowed.

My Lords, my noble and learned friend **Lord Porter** authorises me to say that he agrees with the opinions which have been delivered in this appeal.

Questions Put:

That the Order appealed from be reversed.

The Contents have it.

That the determination of the Commissioners for the Special Purposes of the Income Tax Acts be restored and that the Respondents do pay to the Appellant his costs here and below.

The Contents have it.

[Solicitors :—Solicitor of Inland Revenue; Freshfields, Leese & Munns.]