NO. 1139—HIGH COURT OF JUSTICE (KING'S BENCH DIVISION)—10TH NOVEMBER, 1938

COURT OF APPEAL—31ST JANUARY AND 1ST FEBRUARY, 1939

HOUSE OF LORDS—20TH, 21ST, 22ND, 26TH AND 27TH FEBRUARY AND 8TH MAY, 1940

LOWRY (H.M. INSPECTOR OF TAXES) *v.* CONSOLIDATED AFRICAN SELECTION TRUST, LTD.[1]

Income Tax, Schedule D—Profits of trade—Deduction—Excess of market value over par value of shares allotted at par to employees—Income Tax Act, 1918 (8 *&* 9 *Geo.* V, *c.* 40), *Schedule D*, *Cases* I *and* II, *Rule* 3.

The directors of the Respondent Company, acting under powers given to them by a special resolution of the Company, issued at par to certain employees, in consideration of services, a number of its ordinary shares. The market value of the shares was considerably above par.

On appeal against an assessment to Income Tax under Schedule D for the year 1936–37 *the Company contended that the difference between the market and par values of the shares so issued was allowable as a deduction in computing its profits for Income Tax purposes.*

Held, *that the Company was not entitled to the deduction claimed.*

CASE

Stated by the Commissioners for the General Purposes of the Income Tax for the City of London pursuant to the provisions of Section 149 of the Income Tax Act, 1918, for the opinion of the High Court of Justice.

1. At a meeting of the said Commissioners held on the 21st day of June, 1937, at Gresham College, Basinghall Street, in the said City, the Consolidated African Selection Trust, Ltd., an incorporated company having its registered office at Selection Trust Building, Mason's Avenue, in the said City (hereinafter called "the Respondent") appealed against an assessment to Income Tax made upon

[1] Reported (K.B.) [1938] 4 All E.R. 689; (C.A.) 160 L.T. 220; (H.L.) [1940] A.C. 648.

it under the Rules applicable to Schedule D of the Income Tax Acts in the sum of £190,934, less wear and tear, for the financial year ended on the 5th day of April, 1937.

2. The question for the determination of the Commissioners was whether the Respondent was entitled to deduct in computing its profits for Income Tax purposes an amount representing the difference between the par value and the market value of certain of its shares which had been allotted by the Respondent to certain of its employees as remuneration for services.

3. The Respondent was incorporated on the 11th day of October, 1924, under the Companies Acts, 1908 to 1917, as a company limited by shares with a capital of £250,000 divided into 1,000,000 shares of five shillings each.

4. The objects for which the Respondent was established included (*inter alia*) the following :—

(*a*) To acquire and hold shares, stocks, debentures, debenture stock, bonds, notes, obligations and securities, issued or guaranteed by any company constituted or carrying on business in any part of the world, and debentures, debenture stock, bonds, obligations and securities issued or guaranteed by any government, sovereign, ruler, commissioners, public body or authority, supreme, municipal, local or otherwise, whether at home or abroad, and to acquire, exercise and turn to account options to subscribe for any such shares, stocks, debentures, debenture stock, bonds, notes, obligations or securities as aforesaid.

(*b*) To acquire any such shares, stocks, debentures, debenture stock, bonds, obligations or securities, by original subscription, tender, purchase, exchange or otherwise and to subscribe for the same either conditionally or otherwise, and to underwrite or guarantee the subscription thereof, and to exercise and enforce all rights and powers conferred by or incident to the ownership thereof, or by or incident to any such option as aforesaid.

(*c*) To undertake and to carry into effect financial, commercial or trading businesses in all their respective branches and in particular but without prejudice to the generality of any of the objects for which the Company is established, to enter into, adopt and carry into effect, with or without modification, two agreements, the first being dated the 24th day of September, 1924, and made between Cull and Company of the one part and The Selection Trust, Ltd., as trustee for the Company of the other part, and the second being dated the 25th September, 1924, and

made between the several companies and persons whose names are set out in the Schedule thereto of the one part and The Selection Trust, Ltd., as trustee for the Company of the other part.

(*d*) To seek for and secure openings for the employment of capital in any part of the world and with a view thereto to search, prospect for, explore, develop, work and maintain diamond, gold, silver, copper, coal, iron, bitumen, petroleum, asphalt, and other mines, mineral and other rights, properties and works, whether the Company possesses any defined interest therein or not and to carry on and conduct or assist in carrying on and conducting the business of raising, crushing, washing, smelting, reducing, amalgamating and refining ores, metals, precious stones and minerals, including petroleum, and render the same merchantable and fit for use, and to buy, sell, manufacture and deal in minerals, and mineral substances, plant, machinery, implements, conveniences, provisions and things capable of being used in connection with mineralogical or metallurgical operations, or required by workmen and others employed by the Company, or in or about any work with which the Company is associated.

* * * * *

A copy of the memorandum and articles of association of the Respondent is annexed hereto, marked " A ", and may be referred to as part of this Case[1].

At all times material to this appeal the Respondent has carried on the business of searching for and winning diamonds.

The Respondent makes up its accounts to the 30th June in each year.

5. At an extraordinary general meeting of the Respondent held on the 6th day of December, 1933, (*inter alia*) the following resolution was passed as a special resolution :

2 (*a*) That the capital of the Company be increased to £600,000 by the creation of 250,000 redeemable preference shares of £1 each conferring such rights and privileges and redeemable in such manner as is provided in the new article 55(*b*) hereinafter set forth and 400,000 new ordinary shares of 5*s*. each ranking *pari passu* in all respects with the existing ordinary shares of the Company and that 10,000 of such new ordinary shares be reserved for issue to employees of the Company at such time or times and upon such terms and conditions as the directors shall determine.

The aforesaid " new article 55 (*b*) " is not material for the purposes of this Case.

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(1) Not included in the present print.

6. At a meeting of the board of directors of the Respondent held on the 6th day of June, 1934, the following resolution (*inter alia*) was passed :

" SHARES TO BE ISSUED TO EMPLOYEES

" 14. It was resolved

" That the Chairman and Vice-Chairman be authorised to " settle the distribution and to allot and issue on such " terms and conditions as they shall determine up to a " total of 6,000 ordinary shares to employees, under the " special resolution 2 (*a*) passed at the Extraordinary " Meeting held on 6th December, 1933 ".

7. On the 15th day of June, 1934, the following letter was dispatched by the Respondent to certain members of its staff :

" Dear . . . .

" The Directors desire to show their appreciation of special " services you have rendered to the Company, by giving you " an opportunity to acquire a share interest in the Company " on favourable terms. If you will kindly fill up and return to " the Secretary the enclosed form of application for . . . . . " shares, together with a remittance for £ . . . . . , being " payment in full at par, namely 5*s.* per share, you will in " due course receive an allotment.

" Yours faithfully,

" (*Signed*) A. CHESTER BEATTY."

8. At a meeting of a committee (composed of the Chairman and Vice-Chairman aforesaid) of the said board of directors held on the 2nd day of July, 1934, it was resolved :

" That 6,000 ordinary shares Nos. 999,112 to 1,005,111 " inclusive be and they are hereby allotted to the parties named " and in the proportions set out against their names respec- " tively in the allotment sheets now produced and initialled " by the Chairman for identification, such allottees being the " employees or the nominees of the employees, authorised by " the Chairman and Vice-Chairman to apply, pursuant to " Minute No. 14 of the Board Meeting held on 6th June, 1934 : " the said shares being allotted at par and to rank *pari passu* " in all respects including dividend rights with the existing " issued ordinary shares of the Company ".

At the same meeting the secretary reported to the directors that a total of £1,500 had been received, being payment in full for the 6,000 shares allotted above.

9. On the 10th day of July, 1934, ordinary share certificates representing the said 6,000 shares were duly sealed and issued to the employees concerned.

10. On the 2nd day of July, 1934, the date of the resolution referred to in paragraph 8 above, the market price of an ordinary share of the Respondent was $2\frac{3}{16}$ to $2\frac{1}{4}$. Permission to deal in this further issue was granted on the 11th July, 1934, and the opening price was £2 2*s*. 6*d*. to £2 5*s*. 0*d*. The value of the remuneration for services represented by this issue of 6,000 shares to the employees was accordingly calculated as follows:

6,000 shares at middle market price @ £2 3*s*. 9*d*. per share	£13,125
Less 5*s*. per share paid by the employees	1,500
Value of the remuneration	£11,625

11. It was agreed that assessments to Income Tax had been made upon such of the employees receiving shares as aforesaid as resided in England, upon the footing that the difference between the par value and the market value of the said shares represented remuneration for their services.

12. Mr. Robert Douglas Peters, the secretary to the Respondent, gave evidence and stated that he had received the said letter of the 15th June, 1934, and had duly applied for shares and paid for them in full at par and the same had been allotted to him. He had been assessed to and had paid Income Tax under Schedule E on the premium value of the shares. Had the Respondent so desired it could at the time in question easily have issued the 6,000 shares aforesaid in the open market at between £2 and £2 5*s*. 0*d*. per share. The offer of shares made by the directors to the employees was solely in the interests of the Respondent's trade.

13. It was contended by the Respondent:—

(*a*) That a sum equal to the difference between the par value and the market value of the shares issued to the employees being remuneration for their services and being an amount forgone by the Respondent was a legitimate deduction in computing the profits of the Respondent for Income Tax purposes.

(*b*) That had the Respondent issued the shares in the open market, it could have utilised the premium it would then have received for the purpose of paying the aforesaid remuneration.

(*c*) That in such case the Respondent's right to debit the said remuneration for the purpose of computing its profits for Income Tax purposes could not have been questioned; and that such right was not defeated merely because the Respondent had adopted a shorter and more business-like method.

14. It was contended on behalf of the Appellant :—

(*a*) That no expense had been incurred by the Respondent in connection with the transactions in question.

(*b*) That if any expense had been incurred it had been incurred on capital account and not on revenue account.

(*c*) That upon allotment of the shares nothing had been forgone by the Respondent because, for good commercial reasons, the Respondent had decided that the shares should be issued to certain of its employees at par.

(*d*) That if anything had been forgone it was a premium upon the issue of the shares and was forgone on capital account and not on revenue account.

(*e*) That the deduction claimed was not a deduction allowable in computing profits and should be refused.

15. The following cases were referred to :—

Weight v. *Salmon*, 19 T.C. 174.
In re Wragg, Ltd., [1897] 1 Ch. 796.
Banco de Portugal v. *Waterlow & Sons, Ltd.*, [1932] A.C. 452.
Golden Horse Shoe (New), Ltd. v. *Thurgood*, 18 T.C. 280.
Atherton v. *British Insulated and Helsby Cables, Ltd.*, 10 T.C. 155.
Bradbury v. *English Sewing Cotton Co., Ltd.*, 8 T.C. 481.
Commissioners of Inland Revenue v. *Ramsay*, 20 T.C. 79.
Commissioners of Inland Revenue v. *Bell*, 12 T.C. 1181.

The Commissioners allowed the appeal.

The Inspector of Taxes thereupon expressed dissatisfaction with the finding of the Commissioners as being erroneous in point of law and required us to state a Case for the opinion of the High Court of Justice, which we have stated and do sign accordingly.

JOHN PAKEMAN
J. P. BLAKE
ALAN HOTHAM
C. W. LAMPSON

COPLEY D. HEWITT,
Clerk to the said Commissioners.

10th May, 1938.

The case came before Macnaghten, J., in the King's Bench Division on the 10th November, 1938, when judgment was given in favour of the Crown, with costs.

The Solicitor-General (Sir Terence O'Connor, 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 Company.

JUDGMENT

Macnaghten, J.—This is an appeal by way of a Case stated by the Commissioners for the General Purposes of the Income Tax for the City of London in which the Consolidated African Selection Trust, Ltd., is the Respondent.

The Respondent Company was incorporated on the 11th day of October, 1924, under the Companies Acts, 1908 to 1917, as a company limited by shares, with a capital of £250,000, divided into one million shares of 5*s*. each. By a special resolution passed on the 6th December, 1933, the capital was increased to £600,000 by the creation of 250,000 redeemable preference shares of £1 each and 400,000 new ordinary shares of 5*s*. each, ranking *pari passu* with the existing ordinary shares of the Company. By the special resolution increasing the capital of the Company, it was also resolved that 10,000 of the new ordinary shares should be reserved for issue to employees of the Company at such time or times and upon such terms and conditions as the directors should determine. In the following year, on the 6th June, 1934, the directors, pursuant to the authority given to them by that resolution, determined to offer 6,000 of the ordinary shares to the employees of the Company at par. The letter informing the employees of that decision stated that the directors desired to show their appreciation of the special services that the employees had rendered to the Company by giving them an opportunity to acquire a share interest in the Company on favourable terms. The shares were offered to the employees at their nominal value of 5*s*. per share. At that time the shares, which were quoted on the London Stock Exchange, were saleable in the market at between £2 and £2 5*s*. 0*d*. per share, so the issue of the shares at par amounted in fact to a gift of some £2 per share. The question raised in this case is whether, in the assessment to Income Tax made upon the Company under the Rules applicable to Schedule D for the financial year ended 5th April, 1937, the difference between the nominal and the market value of the shares issued to the employees should be included as a revenue expense. Following the decision in the case of *Weight* v. *Salmon*, 19 T.C. 174, the employees have been assessed to tax upon that sum, as part of their emoluments in the service of the Company.

I have had the advantage of listening to a lucid argument by Mr. Tucker in support of the view which found favour with the General Commissioners. His argument, as I understand it, is this. The Company, by issuing these shares at 5*s*. to its employees, forwent the premium which it might have got if it had issued the shares on the market, and therefore it must be treated (and this is the jump that he takes, which I find myself unable to take with him) as if it had disbursed that amount; and in support of his argument he cited the case of the *Golden Horse Shoe (New), Ltd.* v. *Thurgood*, 18 T.C. 280. In that case the company had acquired

certain dumps, consisting of the tailings of a gold mine, tailings which contained some gold which could by some process be extracted. The company acquired these dumps by paying for them in shares credited as fully paid. The vendors got the shares and the Golden Horse Shoe (New), Ltd., got the dumps. The question in that case was whether the cost of the dumps could properly be regarded not as a capital but as a revenue expense. That question was decided in favour of the company, and the cost of the dumps was carried into the accounts as a revenue expense at a sum equal to the nominal value of the shares which had been given in exchange for them. That was the price at which the company had agreed to buy the dumps, and, therefore, that was the sum to be inserted in the revenue account as their cost. If in that case the Court had said that for the purposes of the revenue account the price which the company paid in shares should be disregarded, and some other value should be placed on the dumps, that might have assisted the argument of Mr. Tucker; but since the nominal value of the shares issued in exchange for the dumps was taken to be the amount which they had cost, I do not think it assists his argument at all.

The simple answer to the claim put forward is that which I have already indicated. The fact that the directors thought it advisable to let the employees have these shares at a price below that which could be obtained from the public is no justification for treating the premium which the Company might have obtained, but did not in fact obtain, as an expense. Moreover the premium, if it had been obtained, would have been a capital receipt. I think that the General Commissioners were mistaken in the view which they took of the matter, and the appeal must be allowed.

Mr. Tucker.—Would your Lordship like to mention at any rate the fact that I cited *Usher's* case(1) as an authority?

Macnaghten, J.—Yes.

The Solicitor-General.—There never would be any question about that.

Mr. Tucker.—I cited it as an authority for the proposition that the forgoing of the amount amounted to a trade disbursement.

Macnaghten, J.—It does not seem to me that *Usher's* case has any application to the question before me. In that case a brewery company owned tied houses which were included in its brewery business for the purpose of assessment to Income Tax. The tied tenants paid rents which were less than the Schedule A

(1) Usher's Wiltshire Brewery, Ltd. *v.* Bruce, 6 T.C. 399.

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assessments of the licensed houses. The loss that the brewery company incurred by reason of that fact was held to be a loss which should be included in the revenue account as an expense of the trade. That has no bearing upon this matter, where the question is: can the Company treat as an expense in the conduct of its business the advantage or benefit which it gave to its employees by permitting them to subscribe for shares at a price less than that which others would pay for them?

The Solicitor-General.—I ask that the appeal be allowed with costs.

Macnaghten, J.—The appeal will be allowed with costs.

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., and Finlay and Luxmoore, L.JJ.) on the 31st January and 1st February, 1939, and on the latter date judgment was given unanimously against the Crown, with costs, reversing the decision of the Court below.

Mr. J. Millard Tucker, K.C., and Mr. Terence Donovan appeared as Counsel for the Company, and the Solicitor-General (Sir Terence O'Connor, K.C.) and Mr. Reginald P. Hills for the Crown.

JUDGMENT

Sir Wilfrid Greene, M.R.—This is an appeal by the Consolidated African Selection Trust, Ltd., from a decision of Macnaghten, J., who reversed the decision of the General Commissioners of the City of London on an appeal in which the Company was claiming to have allowed to it for the purpose of its Income Tax assessment for the year ending the 5th April, 1937, a certain deduction. The Company is a prosperous company, and on the 6th December, 1933, it passed a special resolution increasing its share capital by the creation of certain redeemable preference shares and 400,000 new ordinary shares of 5*s*. each. By the same resolution it was resolved that 10,000 of such new ordinary shares be reserved for issue to employees of the Company at such time or times and upon such terms and conditions as the directors should determine. The directors determined to issue 6,000 of those ordinary shares to employees of the Company upon terms which would give to those employees a substantial benefit, and that benefit was to be by way of remuneration for services rendered. Accordingly on the 15th June, 1934, a letter was sent to the employees in question offering to give them an allotment of the new ordinary shares at par, that is to say 5*s*. a share. That offer was accepted. The 5*s*. was paid, and the 6,000 shares, which was

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the number the directors had determined to allot in this way, were issued to the employees. It is found in the Case that the value of that opportunity to subscribe for the shares at par was £2 3*s*. 9*d*. per share less the 5*s*. paid; that is to say, each employee received by way of remuneration a benefit equivalent in cash value to £1 18*s*. 9*d*. The employees were assessed to Income Tax in that amount, and that assessment was justified by the law as laid down in the case of *Weight* v. *Salmon*, 19 T.C. 174. It is agreed, and the case proceeds upon the footing, that if the Company, instead of making the issue in the way it did, had issued those shares to the public, it could have obtained for them £2 3*s*. 9*d*. per share; that is to say, it would have obtained a premium of £1 18*s*. 9*d*. Had it done so, the premium so obtained in the hands of the Company would have been free money in the sense that the Company could have used it for any purpose that it chose. It could have used it to pay current expenses. It could have carried it to reserve. It could have used it for the purpose of acquiring a capital asset. In other words, so far as the law is concerned, the Company could have dealt with the money received in respect of the premium in any way that it pleased, including, of course, if it had so minded, remuneration of employees. Now, the position when the Company created those new shares was this. When the shares were created the Company acquired the power to admit to membership such persons as should subscribe for those shares. That right was one of value to the Company, because if the Company had exercised that right it could have secured for itself not merely the par value of the shares which by law it would be bound to obtain, because it could not issue shares at a discount, but it would also have been able to obtain a premium. It therefore had a right which was of value to itself, the exercise of which would have brought money into its coffers. That right the Company did not exercise. Instead of doing so, it diverted into the pockets of its employees the equivalent of the cash profit which it otherwise would have obtained. It may be said from one point of view that it forbore to make that cash profit and presented its equivalent instead to the employees. In those circumstances the Company claims to have allowed, as a deduction for the purpose of its assessment, the value of that premium which it might have obtained; or, putting it in another way, the amount of the special remuneration which it has given to its employees. It is incontestable that the Company has remunerated its employees; it is incontestable that the remuneration in the hands of the employees is liable to tax. From where did that remuneration come? It did not come out of nothing. It came from somewhere. The place where it came from was the Company. The Company has provided that remuneration, and it has provided it out of a right belonging to itself, namely, the right to issue those shares.

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Now, it is said on behalf of the Crown that although the employees have received remuneration for which they stand to be taxed, the Company is not entitled to the deduction of the equivalent amount. It is said that to forbear the making of a profit is not an expense incurred by the Company, and it was said that the argument on behalf of the Company, and the decision of this Court if that argument was accepted, would involve affirming the proposition that to forbear making profit is the same thing as incurring an expense. Speaking for myself, I have no intention of affirming any such general proposition, nor did the argument presented on behalf of the Company expressly or impliedly affirm any such proposition. The question that we have to decide lies in a very much narrower compass.

In the course of the argument the question was approached by steps, pursuant to certain questions which were put to Counsel for the Crown from the Bench, and taking an illustration suggested by the speech of Lord Atkin in *Weight* v. *Salmon*(1), Counsel for the Crown were invited to consider two cases. The first case was where an employer being a company which was mining coal remunerated its director by giving him instead of cash a quantity of coal. The question was: could the company in those circumstances treat the value of the coal so given to the director by way of remuneration as a disbursement for the purposes of the trade? I am not quite sure whether I have the answers right, because there seemed to be some uncertainty in them, but I think I am right in saying that the learned Solicitor-General assented to the proposition that in those circumstances the value of the coal could be deducted. Mr. Hills, on the other hand, unless I am unconsciously doing him an injustice, maintained that in those circumstances the value of the coal could not be deducted, but only its purchase price. However that may be, in the next illustration there was unanimity. The next illustration was this: that the company, instead of giving the coal to the director by way of remuneration, sells it to him at half its value, thereby giving him a benefit which in his hands would be a taxable benefit measured by one-half the value of the coal. The question which Counsel for the Crown were invited to answer was: in that case could the Company deduct as an expense one-half the value of the coal? And here both the learned Solicitor-General and Mr. Hills replied stoutly in the negative, and asserted that the only deduction that could be made was the actual purchase price paid by the director for the coal. I must confess that that answer struck me as a surprising one, because if there is one principle which the Crown quite rightly, quite consistently, and quite successfully, has always stood for in Income Tax law, it is the principle that he who

(1) 19 T.C. 174, at p. 193.

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receives money's worth is for taxation purposes in the same position as he who receives money. I cannot myself understand how it can be asserted that a person who pays remuneration to his servant in money's worth belonging to himself is not entitled to deduct that money's worth as an expense. If an employer having two receptacles, one containing cash and the other containing goods, chooses to remunerate his employee by giving him goods out of the goods receptacle instead of cash out of the cash receptacle, the expenditure that he makes is the value of those goods, not their purchase price or anything else, but their value, and that is the amount which he is entitled to deduct for Income Tax purposes. If, instead of giving the goods to the employee, he gives the employee the privilege of acquiring those goods at less than their value, he is equally remunerating him to the extent of the difference between the cash he receives and the value of the goods which he transfers. I myself do not see how the contrary could be argued for one moment. Nevertheless the foundation of the Crown's argument was based on the proposition that this answer was wrong. Now the importance of that illustration and the relevance of it is, I think, confirmed by the observations of Lord Atkin, which were accepted and agreed to by all the other Members of the House, in *Weight* v. *Salmon*[1], because it is from those observations that the illustration comes. I should say that that was a case where it was sought to assess the directors on the premium value of shares in their company for which they had been given the privilege of subscribing; I forget whether it was at par or at a price below market value. That assessment was upheld in the House of Lords. At page 193 Lord Atkin said this: "I think "it is really impossible to appreciate the argument which suggests "that that was not an immediate profit in the nature of money's "worth received by the Director as remuneration for his services. "It appears to me to correspond very closely in substance to a case "where a company might have sold 1,000 tons of its product, if the "company were a colliery company, to a director who was in the "coal trade, at a price which was one-third of the market price of "the day. There no question could arise that the person was "receiving a profit in the nature of money's worth and he was "receiving that profit in the nature of money's worth to the extent "of the difference between the price he could get for it and the price "he had actually paid". It is perfectly true that the case that Lord Atkin was dealing with there was the case not of the payer but of the recipient. Nevertheless it seems to me that, in the case that he put, it follows, and necessarily follows, as a matter of principle, that the company which he is imagining there would have been entitled in those circumstances to treat as a deduction the difference between the cash paid by the director and the value

(1) 19 T.C. 174, at p. 192.

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of the coal that was given to him. That was the method of remunerating the director. It was a remuneration in money's worth. To say that the director was receiving money's worth for his remuneration on which he was to be taxed, and in the same breath to say that the company, which out of its own assets and to its own detriment provided that exact money's worth by way of remuneration, was not entitled to deduct the value of what it handed over, seems to me to produce an inconsistency which even in Income Tax law would be surprising, and I myself am quite unable to accept it.

Now, of course, in the present case the facts are not the facts assumed in that example. Nevertheless it is, I think, important to notice that the parallel between that case and the present case is one which for all relevant purposes is the same as that used by Lord Atkin in the course of his reasoning, and in my judgment it is a parallel which can be used in the present case where it is the employer whose tax is in issue, and not the employee. The Company, as I have said, was possessed of a valuable right. It is perfectly true that the value of that right was not one which would ever appear in its balance sheet as such. No director, no auditor, would insert as an asset in the balance sheet the value of premiums on unissued shares which the Company might obtain if it chose to make an issue. No one has ever seen such a thing. That does not alter the fact that the Company in its unissued shares, having regard to its financial position, had a valuable right which it could turn into cash. If it issued those shares to the public it would have received that cash from the public. It issued those shares to the employees, but instead of receiving the cash from the employees it allowed the employees to keep that cash by way of remuneration. That being so, I cannot myself see how it can be argued that the Company, by the course that it took, has done otherwise than give to its employees to its own prejudice money's worth which the Company, had it been so minded, could have converted into money; but instead of doing so it has transferred that privilege to the employee. For all relevant purposes it appears to me that the position is a true parallel to the case which Lord Atkin took by way of illustration. A company, instead of selling its coal and thereby putting the market value of the coal into its pocket, gives the coal to its employee at a reduced price below its market value, thereby depriving itself of the possibility of making that profit but using that potential profit to remunerate its employee.

Now, that is what has been done in the present case, and it seems to me that the result is one which necessarily follows. Once it is established, as it was established in *Weight* v. *Salmon*(1), that the value so received by the employee is received by way of

(1) 19 T.C. 174.

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remuneration, it follows that the Company provides that remuneration in meal or in malt, in cash or in kind, and is entitled to deduct the amount which it has so provided.

One other argument was put forward, to this effect: that if the Company had issued its shares to the public and had obtained the premium, that premium would not have been a taxable profit in its hands. That, of course, is indisputable. From that it is argued, as I understand it, that the value of the premium must be treated as capital, and accordingly that the Company has remunerated him out of capital. I must confess, with all respect, that I am quite unable to follow that argument. As I have said, the premium, if it had been received, would have been free money in the Company's hands. To say that it would have been capital or income is completely misleading. That the Company could have treated it as capital in the sense of using it for the purpose of acquiring a capital asset or using it as a capital reserve or something of that kind is perfectly true. It is equally true to say that the Company could have used it as income; in other words, the quality of that sum, had it been received, would have been entirely neutral and would have depended on the volition of the Company and nothing else. The circumstance that for Income Tax purposes it would not have been taxable seems to me irrelevant, and for this reason, that money paid by way of remuneration to an employee is of necessity in its nature for Income Tax purposes a payment on revenue account. It matters not out of what drawer the Company obtains the money or the goods for the purpose of making that payment. That is a matter with which the Revenue has no concern. If the Company draws a cheque on its account to pay its employee, its situation at the time may be such that the only fund available for making that payment is part of its own capital. It may have no profits; it may have no reserves; its sole asset may be the capital fund represented by subscriptions for its shares. Nevertheless when it draws that cheque and pays its employee, as between itself and the Revenue it has incurred a revenue expense, and that revenue expense can be deducted for the purpose of its assessment.

I have not referred so far to any of the authorities which were quoted to us, nor do I find it necessary to refer to any of them except one, and that is the case of *Usher's Wiltshire Brewery, Ltd.* v. *Bruce*, 6 T.C. 399. That was a case in which various points arose, but the point which is relevant to the present discussion was this. The brewery company was interested in a number of public houses which it let to tenants upon terms that the tenants should be subject to the usual tie. Some of those houses were owned by the company as freeholders; of some of them they were leaseholders. But the rents which they charged their tenants were, in the case of the leaseholds, less than the rents the company them-

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selves paid, and, in the cases where the company were freeholders, were less than the Schedule A assessment. The company claimed to deduct for the purpose of their ascertainment of profits the difference between the rents paid by them for the leasehold houses, or the Schedule A assessments, and the rents actually received from their tenants. That claim was upheld, but it is important to notice the ground upon which it was upheld. I will take a passage from the speech of Lord Sumner. There are other passages in the other speeches which, if I read them rightly, are based upon the same view, but that view is most clearly expressed in the passage which I will now read. It is at page 437: " Next as to the rent, A trader " who utilises, for the purposes of his trade, something belonging " to him, be it chattel or real property, which he could otherwise " let for money, seems to me to put himself to an expense for the " purposes of his trade. He does so equally if he hires or rents for " that purpose property belonging to another. The amount of his " expense is *prima facie* what he could have got for it by letting it in " the one case, and what he pays for it when hiring it in the other. " Where he gets something back for it, while employing it in his " trade, by receiving rent or hire for it in connection with that trade, " the true amount of his expense can only be arrived at by giving " credit for such receipt. In principle, therefore, I think that in " the present case rent forgone, either by letting houses, which " the brewers own, to tied tenants at a low rent instead of to free " tenants at a full rack-rent in the open market, or by letting " houses in the same way, which they hire and then re-let at a " loss, is money expended within the first Rule applying to both " of the first two Cases of Schedule D, and that upon the findings " of the Special Case, which are conclusive, it is ' wholly and " ' exclusively expended for the purposes of such trade ' ". It is, perhaps, worth noticing that in a later case in reference to the decision in *Usher's* case[1] the House of Lords again use certain expressions which agree with what Lord Sumner was there saying; that is the case of *Collyer* v. *Hoare & Co., Ltd.*, 17 T.C. 169, and I will read three short passages. The first is from the speech of Lord Warrington, who at page 212 says this: " *Usher's* case " is in no way inconsistent with this view [2]. All that was " decided in that case was that certain expenses incurred by the " owners and certain items of rents forborne by them for the " purpose of extending their trade might properly be treated as " money wholly and exclusively laid out or expended for the " purposes of such trade and therefore forming a proper item of " debit in the account under Schedule D ". Lord Atkin said this at page 213: " Whether the expense allowed in *Usher's* case is

(1) 6 T.C. 399.

(2) *i.e.*, the view that the profits and gains arising from the ownership of lands must be determined exclusively by reference to annual value.

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" based upon a deduction of the Schedule A valuation as on premises " used in the brewers' business mitigated by the sum received from " the tied tenant, or whether it is regarded as a notional sum paid " for the advantage of the tie, it is allowed as an expense incident " to the particular house in respect of which it is incurred ". Lord Tomlin at page 215 says : " In *Usher's Wiltshire Brewery*, " *Ltd.* v. *Bruce*, [1915] A.C. 433(1), where tied houses of a brewery " company were held by the tenants at rents below the Schedule A " valuations, your Lordships' House, as I understand the case, " treated the difference between the rent and the valuation in the " case of each house as rent forgone or money spent exclusively " for the purpose of earning profits and held that expense to be one " which could be deducted for the purpose of ascertaining profits " and gains under Schedule D ". Now, it was suggested that the decision in *Usher's* case was really based upon the narrow language of certain of the Rules applicable to Schedule A valuations. It appears to me that the case is based upon a broader principle, a principle which at any rate in its application to the present case is to my mind clear. As I have said, from one point of view the Company in the present case has forborne to make a profit, but that is really only a partial statement of the position. The Company has not merely forborne to make a profit. The Company has done an active thing, not merely suffered a passive thing; it has remunerated its employee, and it has remunerated its employee to its own financial prejudice by giving to its employee the power which it had itself of obtaining a monetary sum in respect of these shares. As I said earlier in this judgment, there is nothing which I have said which in any way affirms the general proposition that money forgone is money expended. A proposition so wide and so vague is one which this Court would never consciously lay down, and I am quite unable to see that anything in the opinion which I have expressed involves the assertion of any such proposition. Whether or not a company or an employer has given money's worth by way of remuneration to an employee is a question of fact. Whether the company in giving that money's worth has done so to its own pecuniary detriment is again a question of fact. I can imagine cases where a company by way of remuneration to its employee gives the employee a privilege which in his hands has a money value but which in the company's hands has no money value at all. Cases of that kind must be decided upon their own facts. The facts of the present case are narrow and simple, and in my judgment, with all respect to the learned Judge who took a different view of the case, it is a clear one, and the appeal is allowed with costs here and below.

Finlay, L.J.—I agree.

Luxmoore, L.J.—I also agree.

(1) 6 T.C. 399.

Mr. Tucker.—My Lord, may I make the usual application for repayment of tax? We paid tax on the footing of this assessment, and I ask for an Order for repayment with interest at 3½ per cent.

Sir Wilfrid Greene, M.R.—Is that the right figure?

The Solicitor-General.—My Lord, I believe that is right.

Sir Wilfrid Greene, M.R.—Yes.

The Solicitor-General.—I have to ask your Lordship for leave to appeal in this case. The case involves the Revenue in very serious considerations. The application of your Lordship's judgment would extend to most, if not all, cases in which remuneration is partly in kind—cases of collieries, or farmers who allow milk to be received by their employees, and so on. My Lord, the ramifications of the judgment are very extensive. *Usher's* case(1) has never been so extended in terms. The Revenue has always successfully resisted any extension of it on these lines; and for these reasons, and following your Lordship's judgment with great care so far as I have been able to at the moment, and feeling satisfied that those considerations will have to be reviewed, I ask your Lordships if I may have leave to appeal to the House of Lords.

(*Their Lordships conferred.*)

Sir Wilfrid Greene, M.R.—Mr. Solicitor, we all appreciate that from the point of view of the Revenue this matter has some fundamental aspects about it, and we consider that the case is one which might properly and conveniently receive the consideration of the highest tribunal. On the other hand, we do not think it would be right that on a matter in which this Court has formed a clear and unanimous opinion the establishment of matters of principle which are of great interest to the Revenue should be conducted at the expense of one individual taxpayer.

The Solicitor-General.—My Lord, upon that aspect of the matter may I respectfully remind your Lordships that here I have the decision of the Judge in my favour. It is perfectly true the issues to the Revenue are, of course, considerably greater, and the desire to appeal is motived by motives that are not germane to the other side. Nevertheless, my Lord, though obviously I will take leave to appeal if your Lordship puts me on terms, I do not desire to assent without demur, respectfully, to terms being put upon me.

Sir Wilfrid Greene, M.R.—I appreciate that. What you are saying is perfectly proper, if I may say so. Of course, this Court, in giving or refusing leave to appeal, pays the greatest respect to the decision of the Judge below, when it has dissented from his judgment, but the mere fact that it has dissented from the Judge below, if the Court is unanimous and clear upon the point, would not of itself be a ground for giving leave to appeal. You follow that, Mr. Solicitor?

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(1) 6 T.C. 399.

The Solicitor-General.—Yes, my Lord.

Sir Wilfrid Greene, M.R.—I agree it is a consideration and a very important consideration, but in the present case we do not consider it is sufficient to justify us in departing from the course we otherwise would have taken, and therefore we think that leave to appeal could properly be given, but on the terms that the Order as to costs which we have made will not be disturbed, and that the Crown will pay the costs of the Respondent in the House of Lords in any event.

The Solicitor-General.—If your Lordship pleases.

Sir Wilfrid Greene, M.R.—On those terms you can have leave.

The Solicitor-General.—If your Lordship pleases.

Sir Wilfrid Greene, M.R.—The costs here and below you are ordered to pay, and that Order must not be disturbed—in other words, the terms are that you bear those costs as well as the costs in the House of Lords.

The Solicitor-General.—If your Lordship pleases.

The Crown having appealed against the decision in the Court of Appeal, the case came before the House of Lords (Viscount Caldecote, L.C., Viscount Maugham, Lords Russell of Killowen, Wright and Romer) on the 20th, 21st, 22nd, 26th and 27th February, 1940, when judgment was reserved. On the 8th May, 1940, judgment was given in favour of the Crown (Lords Wright and Romer dissenting), reversing the decision of the Court below.

The Solicitor-General (Sir Terence O'Connor, 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 Company.

JUDGMENT

Viscount Caldecote, L.C.—My Lords, this appeal from a judgment of the Court of Appeal, which was delivered by Sir Wilfrid Greene, M.R., allowing an appeal from Macnaghten, J., raises a difficult question concerning the computation of the profits of a trade carried on by a limited company. The Respondent Company, which carried on the business of searching for and winning diamonds, was incorporated on the 11th October, 1924,

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under the Companies Acts, 1908 to 1917, with a nominal capital of one million shares of 5*s*. each. By a special resolution passed at an extraordinary general meeting of the Company on the 6th December, 1933, the capital of the Company was increased by the creation of a number of preference shares and also of 400,000 new ordinary shares of 5*s*. each, out of which 10,000 shares were to be reserved for issue to employees of the Company at such time or times and upon such terms and conditions as the directors should determine. Six months later the directors passed a resolution authorising the chairman and vice-chairman of the Company to allot and issue on such terms and conditions as they should determine up to a total of 6,000 ordinary shares to employees under the special resolution of the 6th December, 1933. Accordingly a letter was written on the 15th June, 1934, to certain members of the staff of the Company in the following terms : " The Directors " desire to show their appreciation of special services you have " rendered to the Company, by giving you an opportunity to " acquire a share interest in the Company on favourable terms. " If you will kindly fill up and return to the Secretary the enclosed " form of application for — shares, together with a remittance " for £—, being payment in full at par, namely 5*s*. per share, you " will in due course receive an allotment ".

In response to this invitation applications were made for the whole of the 6,000 shares so offered and payment was made in full. On the 2nd July, 1934, allotments were made and certificates issued to the applicants. On that day the market price of the ordinary shares was $2\frac{3}{16}$ to $2\frac{1}{4}$, making a middle market price of £2 3*s*. 9*d*. It was therefore calculated that if the new shares had been issued in the open market, a premium at the rate of £1 18*s*. 9*d*. would have been received amounting to a total of £11,625, this amount representing the difference between the middle price of the shares in the open market and the sum paid on allotment. The Respondents claim to deduct this sum in computing their profits for Income Tax purposes.

One other fact appearing from the Special Case must be stated. The employees of the Company resident in England who received these shares were assessed to Income Tax under Schedule E on the premium value of the shares on the footing that they were paid this amount as remuneration for their services. The assessment was justified, as the Master of the Rolls pointed out in his judgment(1), by the law as declared in the case of *Weight* v. *Salmon*, 19 T.C. 174. It was there decided in your Lordships' House that the profit which the taxpayer in that case was in a position to make by going on the market and selling shares allotted to him on payment of less than the market price was an immediate

(1) *See* page 268 *ante*.

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profit in the nature of money's worth received by him. The employees of the Respondent Company have in the same way been treated as receiving money's worth, to the extent of the premium value of the shares, and have been assessed accordingly. Whether the directors intended that this should be the result of their offer of shares to their employees on the terms contained in the letter of the 15th June, 1934, may be open to some doubt. It is at least as likely, if attention is paid to the terms of the letter, that the directors really intended to give their employees a chance of acquiring a share interest in the Company at a favourable price so that they might have what is sometimes called a " stake " in the Company with the success of which their own interests were so closely connected. If the wish of the Company had been that their employees should be remunerated by receiving shares which could be turned into cash, the simple course of making a direct payment of an equivalent amount of cash would have produced precisely the same result. The payments could no doubt have been made out of the ordinary resources of this prosperous Company. If some special provision of funds to meet the payments were required, shares to the necessary amount could have been issued on the open market at the full price obtainable. This course would have allowed the Company without question to treat the payments as trading expenses, and to deduct them from its gross receipts in making up its trading account. The Company chose to take another course which did not involve any expenditure of its money, or realisation of any of its assets. It was perfectly entitled to take that course, even though the result might have been to divert into the pockets of its employees the equivalent of the cash profit which it might otherwise have obtained. In fact, the Company did not obtain the cash profit. It is none the less said on its behalf that it is entitled to make up its trading account as if it had expended a sum of money equal to the premium value of the shares in the remuneration of its employees.

I find no guidance from the fact that the employees have had to pay Income Tax on the premium value of their shares. The assessment on the employees was on the ground that, holding an office or employment of profit, they received a profit therefrom: the right to include a deduction of the amount in question in the trading account of the Company for the purposes of Schedule D must be justified by a finding that the Company incurred a trading expense. The question, therefore, which has to be decided is whether, by reason of the fact that the Company did not make use of the opportunity of issuing shares at a premium, the Company can be said to have incurred a trading expense to the amount of the premium.

My Lords, it is to be observed that the learned Counsel for the Respondents was insistent at the outset of his argument in

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disclaiming any intention to base his case upon the contention that the profit on the shares was forgone and could therefore be deducted as an expense. The foundation for such an argument is to be found, if at all, in some observations by Lord Sumner in his speech in the case of *Usher's Wiltshire Brewery, Ltd.* v. *Bruce*, [1915] A.C. 433, at page 469(1). Those observations, which were cited at length by the Master of the Rolls(2), were as follows: "A trader who utilizes, for the purposes of his trade, something "belonging to him, be it chattel or real property, which he could "otherwise let for money, seems to me to put himself to an "expense for the purposes of his trade. Equally he does so if he "hires or rents for that purpose property belonging to another. "The amount of his expense is prima facie what he could have "got for it by letting it in the one case, and what he pays for it "when hiring it in the other. Where he gets something back "for it, while employing it in his trade, by receiving rent or hire "for it in connection with that trade, the true amount of his "expense can only be arrived at by giving credit for such receipt. "In principle, therefore, I think that in the present case rent "forgone, either by letting houses, which the brewers own, to tied "tenants at a low rent instead of to free tenants at a full rack rent "in the open market, or by letting houses in the same way, which "they hire and then re-let at a loss, is money expended within "the first rule applying to both of the first two cases of "Sched. D". In view of the disclaimer by the Respondents' Counsel of any intention of basing his case on the argument that a profit was forgone in the present case, it is unnecessary to say more about the propositions contained in the passage I have quoted from Lord Sumner's speech than that they may require very careful examination if they are relied on as having the authority of your Lordships' House. The Master of the Rolls, however, did not refer to these observations for the purpose of supporting the argument which Counsel for the Company was at pains to disclaim. On the contrary, the Master of the Rolls expressly rejected the argument. I agree with him so far as I understand the argument, but in any case the word "forgone" as used by Lord Sumner was no more than an apt word to describe the result of a simple arithmetical calculation, namely the deduction of amounts of the rent received by the brewery company from amounts of the annual value or of the rent paid by the brewery company in respect of premises used by the brewery company in selling its liquor. It is clear that any attempt to build upon the use of the expression "rent forgone" any such argument as was, apparently without justification, fathered by the Crown on the Respondents' Counsel must fail.

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(1) 6 T.C. 399, at page 437. (2) *See* page 273 *ante*.

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It is said, however, that the decision in *Usher's* case(1), supported and explained as it is by the case of *Collyer* v. *Hoare and Co., Ltd.*, 17 T.C. 169, was based upon a broad principle which is applicable to the present case. The argument is that the Company parted with money's worth in issuing the shares at par to the employees, or, to use the words of the Master of the Rolls(2), the Company " has remunerated its employee to its own financial " prejudice by giving to its employee the power which it had " itself of obtaining a monetary sum in respect of these shares ". This view of the facts is said to warrant the conclusion on the authority of *Usher's* case that the Respondents are entitled to make the deduction in question. It is therefore necessary to examine *Usher's* case to see whether it really is an authority for this proposition.

The facts of *Usher's* case are familiar. The brewery company owned or rented houses in order to provide places in which the company's liquor could be sold. So far as the freehold houses were concerned, the annual value for the purposes of Schedule A was treated as an expense incurred by the company. In the case of the leaseholds, the rent paid, which as Lord Loreburn pointed out was not other than the proper annual value(3), was an obvious item of expense. Both freeholds and leaseholds were let as tied houses at rents less than the annual value, and the difference was claimed by the brewery company to be a permissible deduction. What is now Rule 3 of the Rules applicable to Cases I and II of Schedule D with its prohibition of certain deductions had on those facts to be considered. Lord Parker (in [1915] A.C., at page 460(4)) called attention to the three points decided on the construction of the Rule in the case of *Russell* v. *Town and County Bank, Ltd.* (13 App. Cas. 418(5)) : first, that the annual value or rent of premises used wholly for the purposes of the trade is a proper deduction in ascertaining the balance of profits and gains; secondly, that the effect of the prohibition now contained in Rule 3 (*c*) could not be extended by implication to cover a deduction which would otherwise be a proper deduction, and thirdly, that what is now Rule 3 (*a*) does not preclude a deduction for the annual value of premises used wholly for the purposes of the trade, though the annual value is not money expended in the ordinary sense of the word. Applying that construction your Lordships' House decided that the deduction claimed was properly made in ascertaining the balance of profits and gains.

The brewery company was treated in the case both of its freehold and of its leasehold premises as incurring an outlay. The

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(1) 6 T.C. 399. (2) *See* page 274 *ante*. (3) 6 T.C., at p. 420.
(4) *Ibid.*, at pp. 430/1. (5) 2 T.C. 321.

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deduction of the outlay, once it had been decided to have been incurred, was no more than an application of the elementary principle stated by Lord Herschell in the case of *Gresham Life Assurance Society* v. *Styles*, [1892] A.C. 309, at page 321(1): " . . . . profits are ascertained by setting against the income " earned the cost of earning it ". With the greatest respect to the Court of Appeal I am unable to find any principle laid down in *Usher's* case(2) which can be applied to the facts of the present case, even assuming that the view of those facts taken by the Master of the Rolls was the one which commended itself to me.

I come back to the facts of this case, and I ask whether the issue of these shares in the manner adopted involved the Respondent Company in any " disbursements or expenses . . . . wholly " and exclusively laid out or expended for the purposes of " its trade. Its capital was intact after the issue of the shares: not a penny was in fact disbursed or expended. Its trading receipts were not diminished, nor do I think it is a right view of the facts to say that the Respondent Company gave away money's worth to its own pecuniary detriment. The Company was entitled to issue its shares at par. It did so, and the Company never received, and never elected to receive, anything more than the par value of the shares. Quite apart from any desire to let the employees have a share interest in the Company, the directors might have had very good reasons for deciding not to issue shares to the Company's employees at a price which could only be justified by an expectation of very high dividends over a long period of time.

I am fortified in this view by the opinion of Lord Davey in the case of *Hilder and Others* v. *Dexter*, [1902] A.C. 474, at page 480. In that case the appellants had subscribed to shares in a company with an option to take further shares at par. The shares rose to a premium and the appellants desired to take them up. Lord Davey's speech contains the following passage: " . . . . " the argument seems to be that the company, by engaging to allot " shares at par to the shareholder at a future date, is applying or " using its shares in such a manner as to give him a possible " benefit at the expense of the company in this sense, that it " forgoes the chance of issuing them at a premium. With regard " to the latter point, it may or may not be at the expense of the " company. I am not aware of any law which obliges a company " to issue its shares above par because they are saleable at a " premium in the market. It depends on the circumstances of " each case whether it will be prudent or even possible to do so, " and it is a question for the directors to decide ".

I should very much regret it if the law was not what, in the light of Lord Davey's opinion, I conceive it to be. If in the

(1) 3 T.C. 185, at p. 193. (2) 6 T.C. 399.

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circumstances of this case the Company must be held to have suffered a financial detriment, or in other words to have incurred an expense, solely by reason of the fact that it did not issue its shares at a premium, very far-reaching results might follow in many cases in which for one reason or another an opportunity of securing some financial advantage is not used. That however does not in any way affect or alter the view I take of this case on the facts. The plain fact as it appears to me is that the cost to the Company of earning its trading receipts was not increased by the issue of these shares at less than their full market value.

In my view this appeal should be allowed and I move accordingly. As to costs I observe that leave to appeal was given on condition that the Order of the Court of Appeal directing that the Crown should pay the costs of the hearing in the King's Bench Division and in the Court of Appeal should not be disturbed and that the Crown should pay the Respondents' costs in your Lordships' House in any event. Although I should be reluctant to interfere with the discretion of the Court of Appeal as to the conditions on which leave to appeal should be given, I venture to think no injustice would have been done in this present case if the matter of costs had been dealt with in the ordinary way.

Viscount Maugham.—My Lords, this is an appeal from an Order of the Court of Appeal allowing an appeal by the Respondent Company from an Order made by Macnaghten, J. The matter arises upon a Case stated by the Commissioners for the General Purposes of the Income Tax for the City of London. The Court of Appeal, allowing the appeal to them, reversed the decision of Macnaghten, J., and restored the decision of the Commissioners.

It is unnecessary to repeat the Special Case, and in the view I take of the appeal it is unnecessary to travel into some of the matters discussed in the Court of Appeal and before your Lordships. The material facts are as follows. The Company (as I shall call the Respondents) was incorporated in 1924 and its main business has been that of searching for and winning diamonds and selling them. Its original capital was £250,000 divided into 1,000,000 shares of 5*s.* each. It has been very successful. On the 6th December, 1933, by a special resolution the capital of the Company was increased to £600,000 by the creation of 250,000 redeemable preference shares of £1 each and 400,000 new ordinary shares of 5*s.* each, and it was resolved that 10,000 of such new ordinary shares be reserved for issue to employees of the Company at such time or times and upon such terms and conditions as the directors should determine. By letter dated the 15th June, 1934, and sent to certain members of the staff, the chairman of the Company stated that the directors desired to show their appreciation of special services which certain members of the staff had rendered

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to the Company " by giving " those members " an opportunity " to acquire a share interest in the Company on favourable " terms ". The shares were standing in the market at a premium, but were offered by the letter at par. In all 6,000 shares in the Company, pursuant to the offer in the letter, were applied for at par (namely, at 5*s*. per share) by these employees and in due course they were allotted to them. The 6,000 shares, of course, formed a part of the 10,000 of the shares reserved for issue to employees, as I have stated, and it is not wholly immaterial to note that the directors were not entitled to do anything except to issue them to employees.

The shares of the Company at that time were quoted in the market at £2 3*s*. 9*d*. per 5*s*. share, and the premiums on 6,000 shares would have amounted to £11,625. If then the 6,000 shares had been allotted to the public at the price of £2 3*s*. 9*d*. per share, the Company would on that footing have received the sum of £13,125, and it is said that if it had then distributed the premiums, namely, £11,625, as a bonus to the employees to whom the shares were in fact allotted, the Company would in that case have been entitled to be allowed that sum as a proper expense or deduction in computing its profits and gains under Schedule D for the year in question. Neither of those things happened and what we have in effect to consider is whether, since the Company has not in fact received any part of the sum of £11,625, the premiums which the Company might have got and expended, but never did get or expend, can be treated as an expense or deduction laid out or expended in some artificial but legitimate sense for the purpose of the trade of the Company. This is a rather difficult proposition to establish in the affirmative. We are invited to consider something which did not take place; and it is to be remembered that in *Blott's* case, [1921] 2 A.C. 171(1), this House declined to be influenced by the argument that the case before it was the same as if the shareholders had received the bonus and paid it back to the company to be retained as capital. The simple answer was that they never received it at all; [1921] 2 A.C., at pages 184, 194 and 200(2).

The same answer might I think be given here. The hypothetical view of the facts is not here the true one. The plain object of the Company, as the resolution and the letter of the 15th June, 1934, show, was to give to the employees in question " an opportunity to acquire a share interest in the Company on " favourable terms ". The directors were making use of their powers to enable this to be done. The terms were favourable in

(1) Commissioners of Inland Revenue *v.* Blott, 8 T.C. 101.
(2) *Ibid.*, at pp. 126, 132 and 135.

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order to make sure that the offer would be accepted. The advantage to a trading company or a business firm of an arrangement as the result of which employees get a stake in the concern is one which has been dilated upon for the past hundred years. It is a false view of the transaction to regard it merely as a present of money or money's worth. The Company, it is true, parts with a right, since shares once issued cannot (except in cases of forfeiture) be issued again; but the nature of this right must now be considered.

In my opinion this appeal largely turns on the nature of the right of a company to issue its shares at any price and on any conditions it thinks fit provided that it does so in good faith for the benefit of the company and does not issue them at a discount (see *Hilder* v. *Dexter*, [1902] A.C. 474). Upon an issue of shares the assets of the company are increased by the amounts obtained from the subscribers. These amounts are obviously not profits or gains of the trade, and they are not liable to be brought into the accounts for Income Tax. It may be said that these amounts are of the nature of capital, but I prefer for the present purpose to say that beyond all doubt they are not profits and gains arising or accruing from a trade, for that goes directly to the question which arises under Schedule D. What I have said is equally true whether the shares are allotted at par or at a premium. The sum of £11,625 which in this case the Company might hypothetically have received for premiums was not an item in its profits and gains. In the ordinary course such a sum would be carried to a reserve account in the balance sheet; but carrying it to some account in the profit and loss account would not have affected the matter. It would not be an item of profit of the trade. Indeed the issue of shares by a limited company is not a trading transaction at all. The corporate entity becomes *pro tanto* larger; but the receipts of the trade on the one hand and the amount of the costs and expenditure necessary for earning these receipts on the other remain unaltered, and it is the difference between these two sums which is taxable under Schedule D. It is well settled that profits and gains must be ascertained on ordinary commercial principles, and this fact must not be forgotten (*Gresham Life Assurance Society* v. *Styles*, [1892] A.C. 309, at pages 316 and 321(1); *Usher's Wiltshire Brewery, Ltd.* v. *Bruce*, [1915] A.C. 433, at page 458(2)).

There is one other fact of importance which must be borne in mind. It is that the Company was not discharging a debt or liability to the employees when it issued the 6,000 shares to them at par. The word "remuneration" has been more than once mentioned in this case as if it described the advantages which the

(1) 3 T.C. 185, at pp. 189 and 193. (2) 6 T.C. 399, at p. 429.

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employees were obtaining by the issue, and I think it has led to some confusion. If money or money's worth in any form, whether from capital or income, is given to an employee in discharge of an ordinary trading obligation or debt due to him incurred in the course of the trade and is accepted as such, I am quite ready to accept the view that the amount of the debt or liability so discharged will find its way into the profit and loss account on ordinary commercial principles and will *pro tanto* reduce the profits for the year for Income Tax purposes. A man's salary with his consent can be paid in meal or malt as well as in money, and that salary is one of the items of expenditure which go to reduce the amount of the profits and gains. If in this case the employees were paying the par value of the shares and also releasing to the Company some amounts of salary due to them the case would be very different from what it is. All we really have before us is that the Company has chosen to issue 6,000 shares at par to the employees and that they have received the benefit of that issue. There is really nothing more. The employees have given up nothing. The Company has not lost or parted with any asset. It has a fewer number of shares remaining for issue; but of course it can create as many more as it pleases. There is here, in my opinion, no transaction of trade at all, nor an item of any kind that ought to be carried to either side of the profit and loss account. If the Company, apart from the issue of the 6,000 shares, made a profit of half a million in the year in question, I am myself wholly unable to understand how it can be said that that profit has been reduced to the extent of a farthing (much less £11,625) by reason of the fact that the Company has 6,000 fewer shares to issue to the public. The Company cannot, even if it would, deal in its own shares, and the latter do not partake in any sense of the nature of stock-in-trade. The issue of shares by a company, whether at par or over, does not affect the profits or gains of the company for the purposes of Income Tax.

My Lords, if there were no authorities to be considered and if the Court of Appeal had not expressed a different view from mine, I should have been tempted to leave the matter there; for in its essence I think it is only necessary in this case to ascertain the profits and gains on ordinary commercial principles. But out of respect to the Court of Appeal, I must now deal, I fear at some length, with some, at least, of the matters and the cases which have, as I think, led them to a wrong conclusion.

I think it is clear that the premiums obtained on an issue of shares are not items of receipt in the account of profits and gains. It must then be asked, what is the event which is alleged in this case to entitle the Respondents to treat the amount of these premiums as a disbursement or expense wholly and exclusively laid out or expended for the purposes of the trade (Rule 3 of the

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Rules applicable to Cases I and II)? The contentions of the taxpayer are set out in paragraph 13 of the Case Stated. It is said in effect that the amount of the premiums is " an amount forgone " by the taxpayer because the shares were issued at less than their market value to the employees as " remuneration " for their services, or, alternatively, that if the Company had issued the shares in the open market it could have utilized " the premium " for the purpose of paying " the aforesaid remuneration ", and could then have debited the amount for the purpose of computing its profits for Income Tax purposes. These are, I think, quite distinct reasons. To the first I think the short answer is that an " amount forgone " is not (with one special exception) deductible, and that there is no principle under which such a sum can be treated as a disbursement or expense of the trade. To the second the reply is that you must look at the events which have happened, not those which never happened, and that there is nothing to show that the premiums in question will ever be obtained by anyone either in the year of assessment or in any subsequent year.

The first point seems to be founded on an expression used by Lord Sumner in the case of *Usher's Wiltshire Brewery, Ltd.* v. *Bruce*, [1915] A.C. 433, at page 469(1). The material question —material for our consideration—in that case was whether a brewery company which had, wholly and exclusively for the purposes of its trade, acquired licensed houses which it let to tied tenants at rents substantially lower than their full letting values, was entitled to deduct as expenses incurred in earning its profits the differences between the Schedule A assessments and the rents paid by the tenants. Lord Sumner, at page 469, observed(1): " A trader who utilizes, for the purposes of his trade, something " belonging to him, be it chattel or real property, which he could " otherwise let for money, seems to me to put himself to an " expense for the purposes of his trade ". A little lower on the same page he says: " In principle, therefore, I think that in the " present case rent forgone, either by letting houses, which " the brewers own, to tied tenants at a low rent instead of to " free tenants at a full rack rent in the open market, ... is " money expended within the first rule applying to both of the " first two cases of Sched. D ". My Lords, with all respect to the memory of a great Judge, I cannot help saying that the reference to " chattels " in the first sentence must be due to a slip, and moreover I do not think the sentence in its wide form can possibly be supported. None of the other speeches gave any countenance to it, and it was certainly not necessary for the

(1) 6 T.C. 399, at p. 437.

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decision of the appeal. The second sentence contains the words " rent forgone ", but I think the words in their context mean only rent which might have been but was not actually received. The decision, so far as it concerned the point as to a deduction for rents, was in truth governed by the previous decision of this House in *Russell* v. *Town and County Bank, Ltd.* (13 App. Cas. 418(1)). I am spared the duty of stating the results of that case because Lord Parker (at page 460 of the report of *Usher's* case(2)) stated with his usual lucidity and acuteness the three points on the construction of the Rule applicable to Cases I and II which were decided in *Russell* v. *Town and County Bank.* The third point decided was that " the first part of the rule " (3 (*a*)) " which " prohibits deductions for disbursements and expenses, not being " money wholly and exclusively expended for the purposes of the " trade, does not preclude a deduction for the annual value of " premises used wholly for the purposes of the trade, *though such* " *annual value is not money expended in the ordinary sense of the* " *word* " (the italics are mine). The main reason for this decision, surprising as it is at first sight, is to be found in Lord Herschell's speech in *Russell* v. *Town and County Bank* (13 App. Cas., at page 425(3)). It depends on the particular provisions of the Income Tax Acts. " It is quite true," Lord Herschell said, " that, strictly speaking, the annual value where the premises are " owned and not rented, is not money laid out or expended for " the purposes of the trade, but it is admitted, and must, I think, " have been admitted, that in either the one way or the other " that deduction is to be made, because inasmuch as it is clear " that even in the case of a dwelling-house, a part of which is used " for purposes wholly unconnected with the trade, the annual value " of the portion which is used for the purposes of the trade is to " be deducted," (that is, under Rule 3 (*c*)), " it is evident that it " can never be contended that in the case of premises used not " for the purpose of a dwelling at all, but exclusively for trade " purposes, the annual value is not to be deducted." This reason is, I think, decisive, but it seems to me to be beyond doubt that there is no ground for extending this artificial and unusual construction of the Rule to anything beyond the annual value of premises exclusively used for business purposes, and that *Usher's* case has no application in the present appeal. The ground of the decision, as Lord Herschell's speech in the earlier case clearly showed, is limited to premises used exclusively for the purposes of the business. I do not understand how the reasoning of those cases can throw any light upon the present case, and I am unable to agree with the Master of the Rolls that *Usher's* case is laying

(1) 2 T.C. 321. (2) 6 T.C. 399, at pp. 430/1.
(3) 2 T.C., at p. 328.

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down some broad, though undefined, principle which may extend to all sorts of cases in which the taxpayer has " forgone " a profit. Where are we to stop? If a company chooses to make a sale of goods at cost price to a subsidiary company, is the former to be allowed to make a deduction of the difference between market value and cost price in its profit and loss account on the ground that it is profit forgone? I do not believe anyone would so contend; but for myself I am unable to think of any concrete example of a " profit forgone " in relation to goods and chattels or services rendered which would stand the test of justifying the deduction on ordinary business principles.

If we turn to the second point it is to be observed that it is only in an exceptional case that either the Crown or the subject is entitled to claim on the basis of a transaction which has not taken place. There are no doubt cases where, for example, a payment in cash is deemed to be the result of an accord and satisfaction. You need not pass cheques backwards and forwards across a table. But we have nothing of that kind here. The Company was issuing the shares at par without any juggling with cheques: it was a plain straightforward offer and acceptance of shares at par followed by an allotment. It is said by the Master of the Rolls that the Company has remunerated its employees to its own financial prejudice by giving to them the money's worth of the premiums on the shares allotted to them. I would prefer to say " has made " a present to its employees ". The words " to its own financial " prejudice "(1) do not, I think, advance the argument, for all they mean is that certain shares have been issued at par while they might have been issued at a higher price. How does that lead us to the conclusion that moneys have been " laid out or expended " for the purposes of the trade? For myself I do not think the premiums which might have been obtained are " money's worth " in the sense in which those words are generally used, that is, as an equivalent for cash paid by the Company, and in my opinion that view is supported by the case I must next refer to. But whether or not that is so, I repeat that in this case the sum of £11,625 which the Company never obtained was not in any sense laid out or expended for the purposes of the trade.

My Lords, I think this House in the case of *Hilder* v. *Dexter*, [1902] A.C. 474, decided by necessary inference that although a premium obtained by a company on an allotment of its shares is obviously money belonging to it and is *prima facie* part of the capital of the company, nevertheless the advantage which an allottee of shares at less than the market value of the shares obtains is not either money or money's worth belonging to the company

(1) *See* page 274 *ante*.

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nor is it part of the capital of the company. That was a decision on Section 8 (2) of the Companies Act, 1900. Lord Halsbury, L.C., took the responsibility for its drafting ([1902] A.C., at page 477) but I cannot say that the Section is an example of lucidity, and it is necessary to study the case with some care to discover precisely what was being decided. The first Sub-section of Section 8 states the conditions under which a company might pay a commission to a person in consideration of his agreeing to subscribe for shares. It required disclosure and provided a limit of the amount. The second Sub-section stated shortly runs thus: " Save as aforesaid no company shall apply any of its shares or " capital money either directly or indirectly in payment of any " commission . . . . whether the shares or money be so applied " by being added to the purchase money of any property acquired " by the company or to the contract price of any work to be " executed for the company, or the money be paid out of the " nominal purchase money or contract price, or otherwise ". The Section therefore prohibits the payment of such a commission out of shares of the company or money coming from the allotment of shares in the company and out of any money belonging to the company with, however, the possible exception of the earned profits of the company. Lord Davey's speech, concurred in by Lord Halsbury and Lord Robertson, shows this quite clearly, though he does not mention the possible exception I have referred to. He points out that the words " apply any of its shares or capital " money " include money derived from the issue of shares (at page 480, line 7). A little lower down the same page he observes that the company in the case before the House was not indeed parting " with any moneys belonging to it " (the company). He then had to deal with the words " directly or indirectly ". The argument was that this prevented the company from " applying " or using its shares in such a manner as to give " the person promising to subscribe for shares " a possible benefit at the expense " of the company in this sense, that it forgoes the chance of issuing " them at a premium ". Here we come across precisely what is said in this case. Lord Davey, however, deals with the point by saying that there is no law " which obliges a company to issue its " shares above par because they are saleable at a premium in the " market ", and that " the benefit to the shareholder from being " able to sell his shares at a premium is not obtained by him at " the expense of the company's capital ". If this House had regarded the transaction as one in which the company was giving " money's worth " in the sense of an equivalent for cash in consideration of the promise to subscribe for shares the decision would have been the other way. The words " directly or indirectly " would have been in point.

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On the other hand there is no doubt at all that a man who gets a share standing in the market at £2 3*s*. 9*d*. for the sum of 5*s*. is himself getting an advantage of considerable value. The point of *Hilder* v. *Dexter*(1) for the present purpose is that he is not getting it in any true sense at the expense of the company, though no doubt the company has forgone the chance of making a profit, which, as I have pointed out above, would usually be treated as capital.

The decision of this House in *Weight* v. *Salmon* (151 L.T. 410; 51 T.L.R. 333(2)) is also invoked by the Respondents. It was there held that directors could properly be assessed on the premium value of shares in their company for which they had been given the privilege of subscribing. Since the allottee at par of shares standing at a premium is plainly getting an advantage capable of being turned into money, it is easy to arrive at the conclusion, if Schedule E applies to him, that the market value of the shares less the amount he pays is within the wide words of Rule 1 of that Schedule—" salaries, fees, wages, perquisites or profits whatsoever ". I can see no difficulty in that case, but I have a difficulty in appreciating its application to the one before us. It depended on the language of the Rules applicable to Schedule E, while the problem which arises under Schedule D seems to me to be a very different one, since it concerns profits of a trade and is subject to a large number of prohibitions as to the deductions which alone are permissible and on other statutory rules of some complexity.

It is of course clear that if a company owing, say, £500 to an employee for his contractual salary agrees to deliver to him so many tons of coal or any other marketable commodity in discharge of the £500, the company would then be entitled to deduct the £500 as an expense. I only mention this for the purpose of remarking once more that it is not the present case. A number of other questions have been raised as regards the giving of coal and other commodities to employees. I do not wholly agree with what the Court of Appeal has said in relation to those matters; but I do not think they arise on the present appeal and for my part I think it will be wiser not to express an opinion on them.

In conclusion I return to the view which I expressed earlier in this judgment. A company, generally speaking, can issue its shares at any price it likes, not being less than par. This is not a trading transaction, and does not in any way affect its gains and profits under Schedule D. In the present instance the shares were issued at par to certain employees in order to give them an interest in the Company, but not in payment of any sum contractually due to them. In these circumstances the Respondents have failed to establish that

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(1) [1902] A.C. 474. (2) 19 T.C. 174.

(Viscount Maugham.)

any sum has thus been expended or laid out for the purpose of the trade of the Company.

My Lords, it follows in my opinion that the appeal should be allowed.

Lord Russell of Killowen.—My Lords, the Respondents in this case claim that in computing the profits of their trade assessable to Income Tax, there should be deducted a sum which they have not disbursed, and in respect of which they have incurred no liability.

I will not recount all the facts; they have already been stated. I must, however, call attention to one important matter. The claim is made upon the footing that the sum in question represents remuneration paid by the Respondents to their servants, but the transaction as evidenced by the documents does not, I think, warrant this terminology. The sum in truth represents the premium on certain shares which the Respondents might have issued to the public at a price above par, but which they elected to offer to their servants at par, in order to induce them to become shareholders, and, therefore, servants directly interested in the welfare of the Company. That is an accurate description of the transaction. The hope and intention were that the servants should keep the shares. No doubt the servants had it in their power to sell and obtain a premium from their purchasers. No doubt, too, they, or such of them as were liable to Income Tax, would be taxable on the benefit which accrued to them from the allotment at par. These, however, are considerations irrelevant to the question which we have to determine, namely, whether the Respondents are entitled to deduct as a trade expense a sum equivalent to the premium at which the Respondents might, had they so chosen, have issued the shares.

The Court of Appeal answered this question in the affirmative, but in my opinion, the deduction is not permissible. I have considered with care the judgment delivered by the Master of the Rolls. It rests, I think, on two foundations: one, that the Respondents transferred money's worth from themselves to their employees; the other, that upon the authority of *Usher's* case, [1915] A.C. 433(1), the premium which the Respondents elected not to obtain was a " profit forgone " which they were entitled to enter on the expenses side of their trading account in ascertaining their trading profits. It is true that the Master of the Rolls emphatically disclaims any assertion of the general proposition that money forgone is money expended, but the exact limits within which the proposition may apply are not very clearly marked.

There is no difficulty about the cases, indicated in the course of the judgment, in which a servant is remunerated in kind. The

(1) 6 T.C. 399.

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value of the " kind " must be deducted in ascertaining the profits of the trade, subject however to this, that if the " kind " is part of the trader's stock-in-trade, further entries must be made in the account if it is desired to ascertain the profit made by the realisation of all the stock-in-trade realised; for the " kind " which is applied at its value in remunerating the servant is stock-in-trade realised just as much as if sold at that value to a customer. The value of the " kind " should, I think, be included in the receipts as representing a realisation at the value at which it discharges *pro tanto* the servant's salary, and the expenses should include in addition to the cost of the whole stock-in-trade an item representing the whole amount of that salary. I am throughout assuming that the cost is lower than the market value. But transactions such as that do not represent what in fact happened in this case. Here the Respondents in my opinion parted with nothing; they transferred no asset of theirs to the servants. The power of a limited company to issue and allot shares is not an asset of the company; it is only a power to increase its issued capital and, it may be, the number of the corporators. It is not bound to issue its shares for more than their nominal value. The words of Lord Davey in *Hilder* v. *Dexter*, [1902] A.C. 474, at page 480, may be quoted: " . . . . the " argument seems to be that the company, by engaging to allot " shares at par to the shareholder at a future date, is applying or " using its shares in such a manner as to give him a possible benefit " at the expense of the company in this sense, that it forgoes the " chance of issuing them at a premium. With regard to the latter " point, it may or may not be at the expense of the company. I " am not aware of any law which obliges a company to issue its " shares above par because they are saleable at a premium in the " market. It depends on the circumstances of each case whether it " will be prudent or even possible to do so, and it is a question for " the directors to decide. But the point which, in my opinion, is " alone material for the present purpose is that the benefit to the " shareholder from being able to sell his shares at a premium is not " obtained by him at the expense of the company's capital ". I am of opinion that the first basis of the judgment of the Court of Appeal fails because the Respondents transferred neither money nor money's worth to their servants; they merely elected not to obtain more than the nominal value of the shares in order to induce the servants to become shareholders in the company. I cannot hold (apart from compelling authority) that such action by the Respondents is, or may be treated as, a disbursement or an expense; or that the premium, which the servants could, if they wished, obtain from purchasers of their shares, is or may be treated as money laid out or expended by the Respondents for the purposes of the Respondents' trade.

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It is, however, said that compelling authority does exist in the decision of your Lordships' House in the case of *Usher's Wiltshire Brewery, Ltd.* v. *Bruce*, [1915] A.C. 433(1), and I now proceed to consider this question.

The matters there in debate which are relevant to the present case were two—namely (1) the freehold tied houses which the brewery let to tenants at rents lower than the Schedule A assessment and (2) the leasehold tied houses which the brewery sub-let to tenants at rents lower than the rents paid by the brewery to the freeholders. It was held that the brewery could, in ascertaining its profits, charge as an expense (in the first case) the difference between the rents paid by the tenants and the Schedule A assessment, and (in the second case) the difference between the rents paid by the tenants and the rents paid by the brewery. In other words, the receipts side of the account included the smaller sums of rent received by the brewery while the expenditure side included the larger sums representing (*a*) the annual value of the freeholds and (*b*) the rents paid by the brewery. Three things may here be noted—namely (1) so far as concerns the leaseholds the position seems to present no abnormal features; it is a plain case of entering actual income and actual outgoings; (2) the great difficulty arose as to the freeholds, in regard to which no actual disbursement or expense was made or incurred by the brewery which could be described as money laid out or expended for the purposes of the trade; and (3) it was never suggested that anything beyond the Schedule A assessment (for example, the amount of a potential rack-rent) could be charged as an expense. It is in regard to the decision concerning the annual value of the freeholds that I propose to consider the case.

This House decided that the annual value could properly be entered as an expense, or, to put it in other words, that the difference between the larger amount of the brewery's assessment under Schedule A and the smaller amount of the rent received from the tied tenant was deductible in ascertaining the brewery's profits for the purposes of Income Tax.

It is important to see how this result was achieved because it is upon the authority of *Usher's* case that the Court of Appeal has relied. Just as in *Usher's* case " rent forgone " was held to be money wholly and exclusively expended by the brewers for the purpose of the trade, so it is said the premium here forgone by the Respondents is money wholly or exclusively expended by them for a similar purpose. Such, as I read the judgment, is the view expressed.

Usher's case, when examined, will prove to be founded, and I think entirely founded, on the earlier decision of this House in

(1) 6 T.C. 399.

(Lord Russell of Killowen.)

Russell v. *Town and County Bank, Ltd.* (13 App. Cas. 418[1]). Lord Parker of Waddington, in *Usher's* case[2], said in terms that it was covered by that decision. The question there was whether in ascertaining the profits of a bank the annual value of the whole of the bank premises was deductible, including that part of them in which the bank manager resided. The difficulty of treating the annual value as a disbursement or expense or as money laid out or expended for the purpose of the trade was fully appreciated, but the difficulty was overcome, and it was treated as a permissible deduction, by reason of the fact that the provision of the 1842 Act which corresponds with the present Rule 3(*c*) of the Rules applicable to Cases I and II of Schedule D showed that in appropriate circumstances annual value might be deducted. Lord Herschell made this clear when he said[3]: "It is quite true that, strictly speaking, the annual value, "where the premises are owned and not rented, is not money laid "out or expended for the purposes of the trade; but it is admitted "and must, I think, have been admitted, that in either the one way "or the other that deduction is to be made; because, inasmuch as it "is clear that even in the case of a dwelling-house, a part of which "is used for purposes wholly unconnected with the trade, the "annual value of the portion which is used for the purposes of the "trade is to be deducted, it is evident that it can never be contended "that in the case of premises used, not for the purpose of a dwelling "at all, but exclusively for trade purposes, the annual value is not "to be deducted. The annual value is therefore to be deducted "somewhere. It is to be deducted either by taking it as an element "before arriving at the balance of profits and gains, or as included "in a very broad construction of the provision relating to disburse-"ments and expenses".

Having thus laid the foundation of the right to deduct the annual value of premises wholly used for bank purposes, Lord Herschell then held that the fact of the bank manager residing in part made no difference, because that part too was used for the purposes of the bank's business, and further that the premises in question were not a dwelling-house within the special statutory provision in that behalf. As I read the decision the right to deduct the annual value of land used for the purposes of trade, whether as a necessary element in arriving at the balance of profits and gains of the trade, or as included under a broad construction of disbursements and expenses, is based upon and justified by the existence of the express provision now represented by Rule 3(*c*).

Both cases are decisions dealing with the ownership by the trading company of land in which Rule 3(*c*) or its predecessor came into consideration as a reason for allowing the annual value to be

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(1) 2 T.C. 321. (2) 6 T.C. 399, at p. 433. (3) 2 T.C., at p. 328.

(Lord Russell of Killowen.)

treated as a permissible deduction. Neither is an authority extending beyond that, and in my opinion *Usher's* case(1), founded as it is on *Russell* v. *Town and County Bank, Ltd.*(2), does not justify the deduction which is claimed by the Respondents. It is true that the language used by Lord Sumner(3), and quoted by the Master of the Rolls(4), is far reaching, and extends even to chattels; indeed, if taken literally it would lead to some startling results. The other members of this House who took part in the debate use no such wide language and I, for one, am not prepared to extend the decision so as to cover the wholly different facts of the present case. Both these decisions relate to the annual value of land, to which peculiar considerations are applicable, and I am unable to see how the reasoning in either of these two decisions of your Lordships' House can be applied to a case like the present, in which the claim is to deduct a sum which never came into existence because the Respondents, in order to achieve a desired result, elected to issue some shares at their nominal value.

As a last argument, it was urged that apart from *Usher's* case, and the Rules, the deduction was permissible on general commercial principles. I do not agree. If the Respondents had issued the shares at a premium, no trace of the transaction would appear in the profit and loss account. I find difficulty in understanding how on any principle, commercial or otherwise, you may, by electing not to get a sum, become entitled to charge as an expense in your profit and loss account the amount of the sum, which if you had got it, could not have been included therein as a receipt.

I am of opinion, for the reasons which I have endeavoured to indicate, that this appeal should succeed.

Lord Wright.—My Lords, the question in this appeal is whether the Respondents are entitled to deduct as an expense from their profits, or, to state it differently, as a proper item in the ascertainment of the balance of profits and gains in the year of charge, the difference between the market value and the par value of 6,000 shares which they allotted to certain of their employees as extra remuneration. The Court of Appeal, agreeing with the experienced City Commissioners, but reversing the decision of Macnaghten, J., have held that they were so entitled. Save for the difference of opinion which has emerged among your Lordships, I should have been content without more to express my concurrence with the judgment of the Court of Appeal delivered by the Master of the Rolls, which to my mind is (subject to some immaterial reservations or differences in emphasis) convincing and satisfactory. But as things are, I feel I ought to explain my reasoning at some length, out of respect to those who take a different view.

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(1) 6 T.C. 399. (2) 2 T.C. 321. (3) 6 T.C., at p. 437.
(4) *See* page 273 *ante*.

(Lord Wright.)

The Respondent Company, which is engaged in the diamond business, has been prosperous, and its shares, the par value of which were at the material time 5*s.* a share, were able to command in the market a price of £2$\frac{3}{16}$ or £2$\frac{1}{4}$ when the new issue, of which the 6,000 shares in question formed part, was made. The Case finds that the value of the remuneration for services represented by this issue of 6,000 shares to the employees was accordingly calculated at £11,625, based on the middle price of the day, namely, £2 3*s.* 9*d.*, less 5*s.* a share paid by the employees. This is a finding of fact by the Commissioners, upon which they upheld the contention of the Respondents that they were entitled to debit this sum in arriving at the balance of their profits and gains, the Commissioners having further held that this offer of the shares to the employees was solely in the interest of the Company. Whether or not the allotment was thus made by way of remuneration is a question of fact. I do not think it is competent for the House to go behind it. In the course of the hearing before your Lordships, it was said that there was no evidence to justify the finding of fact and further that the idea of remuneration was excluded by the terms of the letter in which the directors offered the shares, as fully paid, at 5*s.* a share in order to show their appreciation of the employees' special services by giving them an opportunity of acquiring a share interest in the Company on reasonable terms. But that letter is consistent with the Commissioners' finding that the offer was by way of remuneration, even though it was not merely a reward for past services but had the further object of stimulating future efforts. But even if the latter were the sole element, and even if the word remuneration were not appropriate, it would not, in my opinion, affect the question whether the deduction was admissible. The deduction, if in other respects allowable, would be allowable as an outlay or expense incurred solely in the interest of the Respondents' trade.

But for the divergence of opinion which has emerged, I should have been clear in my mind that the £11,625 claimed as a deduction was properly so claimed. If the Respondent Company had arranged with certain of their employees to satisfy their salary or part of it to the aggregate extent of £11,625 by the allotment of these shares at 5*s.* instead of charging the market price, I do not see how it could be contested that the £11,625 was deductible as a trade expense. It would *pro tanto* wipe off trade debits for wages just as much as if it had been utilised to discharge any other indebtedness. Each employee, by the allotment of the fully paid shares, would be paid what was due to him to the extent of the difference between 5*s.* a share and the market value. He in truth receives a share or chose in action worth £2 3*s.* 9*d.*; though he had to pay 5*s.* for each share (because the Company cannot issue the shares at less than par) that is really a deduction from the gross value which he receives, so that he is only paid, in the

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hypothesis imagined, £1 18*s*. 9*d*. in respect of each share. I shall not express the position as being that he obtains the power to realise a profit of £1 18*s*. 9*d*. What he gets is the share and all the rights which it involves. He may realise it and turn it into cash, or keep it as an investment for income or appreciation. The payment of 5*s*. a share does not make the position in essence different from what it would be if the salary were being paid by a transfer of shares in a subsidiary company which were held by the Respondents and which they could transfer without any payment at all. The only difference is that in such a case the full market value of the shares and not the market value less 5*s*. a share could be reckoned as the sum paid.

I cannot see any distinction between the case supposed where the shares are used to discharge a pre-existing debt for salary and where they are utilised to pay a bonus or extra remuneration. No doubt in the former case the value attributable to the share is expressly liquidated on the footing of the amount of the debt. In the case of the bonus remuneration, the amount of the bonus is only determined by ascertaining what is the value to the employee of the share which he receives, which in the present case is the market value less 5*s*. a share. But I see no difference. In fact the recipient is taxed on precisely this basis as in respect of profits of his office. This practice, which was followed in the present case, has the authority of this House in *Weight* v. *Salmon*, 51 T.L.R. 333(1), where directors who had been allotted at par by way of remuneration fully paid shares which stood at a premium in the market, were taxed on the difference between the market value and the par value. The question from the point of view of the recipient who is taxed under Schedule E is obviously different from that of the Company on its profits under Schedule D. But it is at least clear that the recipient does obtain a profit. In my opinion this profit so obtained was in the facts found at the expense of the Respondents (if I may use the word in its ordinary business sense) and even though in other cases, as Lord Davey points out in *Hilder* v. *Dexter*, [1902] A.C. 474, at page 480, the benefit which the recipient obtains may or may not be at the expense of the company in the sense that it forgoes the chance of issuing them at a premium. Lord Davey says : " I am not aware of any " law which obliges a company to issue its shares above par " because they are saleable at a premium in the market. It " depends on the circumstances of each case whether it will be " prudent or even possible to do so, and it is a question for the " directors to decide ". In the present case any question of this nature is disposed of by the findings in the Special Case, which states that the directors could have issued the shares in the open

(1) 19 T.C. 174.

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market at a premium, but offered them at par to the employees solely in the interests of the Respondents' trade.

The Respondents have parted with an asset at one-tenth of its value in order to further the interests of the Company. The Case states at what price they could have sold the shares in the market. Most people would say that they gave them away, treating the 5*s.* a share as merely a mitigation of what would otherwise be a free transfer, or the difference between the 5*s.* a share and its market value may be regarded, to borrow Lord Atkin's phrase from *Weight's* case(1), as a notional sum paid in order to remunerate the employees or as a sacrifice made to promote the Company's trading. However it is put, the benefit which the employees receive by having the shares at 5*s.* a share is at least in the facts of this case correlated with the corresponding expense incurred by the Respondent Company when they allotted the shares on these terms. It may be that this would be clearer if the difference were being used to pay a debt as for definitely stipulated wages. But I can see no difference in principle. No doubt in that event as a matter of bookkeeping the debt would appear on one side and the difference in value on the other side. But similarly here the extra remuneration paid should appear on one side and the difference in value on the other side of the account. It has been notionally received on capital account, and is being utilised on revenue account, just as would have been the case if it had been used to pay an ordinary debt. It is true that unissued shares are not an asset in any sense of the Company. What value they have only comes when and by the fact that they are issued, just as a deed has no value or indeed existence until it is signed sealed and delivered, or a negotiable instrument until it is issued. Unissued share capital was described by Lord Davey in *Hilder* v. *Dexter* (*supra*(2)) at page 480 as potential capital. The power to issue further capital is only a potentiality. But the fact of issue makes it actual capital, and creates the fasciculus of rights and liabilities between the company and the shareholder which flow from the share when issued. If the share stands at a premium, the directors *prima facie* owe a duty to the company to obtain for it the full value which they are able to get. It is true that it is within their powers under the Companies Acts to issue it at par, even in such a case, but their duty to the company is not to do so unless for good reason. Normally they would transfer the difference between the market value and the par value to a premium reserve or similar capital account. But they could justify issuing the share at par on the ground that the difference has been utilised to secure a benefit to the company, as here by paying the extra remuneration to the employees and it may be also by giving them

(1) 19 T.C., at p. 193. (2) [1902] A.C. 474.

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an interest in the company. In my opinion, when the directors did so the Company was incurring an expense on revenue account deductible as such under Schedule D in order to assess the balance of profits and gains. This is so none the less because the premium, if acquired, would not have been a trading profit but a receipt on capital account.

I think there is authority in this House which in principle and precisely covers this conclusion. I refer in particular to *Usher's Wiltshire Brewery, Ltd.* v. *Bruce*, [1915] A.C. 433(1), where it was held that a trading company which had transferred an interest of value at less than its full value in order to advance its trade was entitled in estimating the balance of its profits and gains to claim to deduct the difference between the full value and the amount which it thus received, as being an expense necessarily incurred for the purpose of earning the profits. The trade in question was that of a brewery company. In the ordinary course of that trade, the company was either owner or lessee of licensed houses which it let to " tied " tenants, who, in consideration of the tie, paid a rent less than the full annual value. It was the difference between the rents and the full annual values which the company was held to be entitled to deduct as an expense of the trade under the Rules applicable to Cases I and II of Schedule D. Lord Loreburn (at page 446(2)) shortly summed up the position : " On ordinary principles of commercial trading such " loss arising from letting tied houses at reduced rents is obviously " a sound commercial outlay ". In the same way, in the present case the loss involved in allotting the shares at less than their market value for the purposes found by the Commissioners is a sound commercial outlay which the Respondent Company are entitled to bring into account. Lord Atkinson stated (at page 451(3)) : " This is only another way of saying that the " appellants let their tied houses at low rent solely and exclusively " for the purpose of promoting their trade and enhancing the profits " of it ". Later on at page 457(4) he compared what would have been the position if the brewery company instead of putting in a tenant into the tied house had put in a manager. In the latter case, on the authority of *Russell* v. *Town and County Bank, Ltd.*, 13 App. Cas. 418(5), the full annual value of the house would have been deductible. " But ", Lord Atkinson proceeded, " the balance " of the profits and gains of the brewer's trade would, according " to the methods of practical business men, be ascertained in the " same way in both cases, i.e., by deducting from the receipts " what it costs to earn them. Part of the cost to the brewer is, " in the manager's case, his salary, and possibly a discount on

(1) 6 T.C. 399. (2) *Ibid.*, at p. 420. (3) *Ibid.*, at p. 424.
(4) *Ibid.*, at p.428. (5) 2 T.C. 321.

(Lord Wright.)

" profits. In the case of the tenant it is the difference between " the annual value of his, the brewer's, freehold house and the rent " he receives for it, and in his leasehold house the difference between " the rent he receives for it and the rent he pays for it, if that be " equal to the full annual value under Sched. A. For for the purposes " of striking the balance of profits and gains the two cases are in " principle undistinguishable ". I draw special attention to these last words as showing conclusively that nothing turned on any feature peculiar to landed interests in Schedule A. Earlier in his speech, at page 452(1), Lord Atkinson said : " . . . . if he " (the trader) " abstains from letting his premises and devotes them to " the purposes of his trade he must be taken to have dedicated to " that trade a sum equivalent to the annual sum which he might " have obtained in the shape of rent if he had let them to an untied " tenant ". It is true that in that case the trade was different and the subject matter was different, but the difference between the brewer's trade and the diamond merchant's, and between the letting of houses and the allotting of shares, must not be allowed to veil what in my opinion is the identity in principle. The undervalue deliberately incurred was a dedication of an equivalent sum to the purposes of the trade. Lord Parker spoke to the same effect. He pointed out(2) that the brewers were claiming to deduct the difference between the Schedule A assessment and the rent they received or the difference between the rent they paid and the rent they received, the former applying when they are freeholders and the latter when they are leaseholders. " In other words," he said, " they " claim the Schedule A assessment value or the rent they pay as " a deduction, giving credit on the other side of the account for " the rent paid by the tenants of the tied houses." He held that they were right in their contention, because it was a deduction not precluded by the First Rule applicable to Cases I and II, and necessary to ascertain the balance of the profits and gains in any true sense of that expression. But he added : " The right to " make the deduction, however, must of course carry with it the " obligations to give credit for the rents received from the tenants " of the tied houses ". I think, notwithstanding certain objections which I shall consider later, that this decision does in principle precisely apply to the case now in question. The brewers were letting their houses at an undervalue in order to promote their trade. They were held entitled to a deduction of the true value, subject to allowance for the rent which they actually received. Here the Respondents are parting with their shares at an undervalue for the purposes of their trade. They are accordingly, it seems to follow, entitled to a deduction of the market value of these shares, subject to an allowance for the par value

(1) 6 T.C. 399, at p. 425. (2) *Ibid.*, at pp. 432/3.

(Lord Wright.)

which they actually receive. The sacrifice in *Usher's* case(1) was of the rents, in the present case of the market value of the shares, less in either case the credits. The fact that Schedule A applies to property in land does not, in my opinion, affect the position, save that the annual value under Schedule A takes the place of market value. Lord Sumner puts this principle very clearly at page 469(2), where he says: " Next as to the rent. A trader who " utilizes, for the purposes of his trade, something belonging to " him, be it chattel or real property, which he could otherwise let " for money, seems to me to put himself to an expense for the " purposes of his trade. Equally he does so if he hires or rents " for that purpose property belonging to another. The amount " of his expense is prima facie what he could have got for it by " letting it in the one case, and what he pays for it when hiring " it in the other. Where he gets something back for it, while " employing it in his trade, by receiving rent or hire for it in " connection with that trade, the true amount of his expense can " only be arrived at by giving credit for such receipt ".

If the " expense " of letting houses at an undervalue for purposes of the trade is a deductible expense under Schedule D, I cannot see why in principle the expense of allotting shares at an undervalue for purposes of the trade should not equally be deductible under Schedule D.

But it was objected that *Usher's* case, like *Russell's* case(3), which to a certain extent it followed, related to rent and that the principle enunciated in these cases was not general, but was limited to deductions in respect of rent. It was sought to maintain this proposition by reference to the Rules applicable to Cases I and II of Schedule D. The contention was that this House decided the two cases referred to not on any general principle but on the specific terms of the Rules which relate to rent or annual value. In the Acts before 1918 these Rules were for practical purposes identical with what is now to be found in Rule 3 (*c*) and in Rule 5 and I shall accordingly refer to the modern Rules. Rule 3 (*c*) deals with the rent or annual value of a dwelling-house and prohibits any deduction in that respect except for such part as is used for the purposes of the trade or profession, etc., of the person claiming the deduction. Rule 5 provides that the computation of the tax shall be exclusive of the profits and gains arising from (or since 1927 of the annual value of) lands, tenements and so forth occupied for the purpose of the trade or profession, etc., of the person being assessed, and separately assessed under Schedule A. I may note in passing that in *Usher's* case the tied tenants, not the brewers, were occupiers of the premises. After a careful study of the Rules and of these two

(1) 6 T.C. 399. (2) *Ibid.*, at p. 437. (3) 2 T.C. 321.

(Lord Wright.)

authorities, I can find nothing to justify putting this limited interpretation on the principles laid down. I do not wish to repeat all that was said on this point by Lord Herschell in *Russell's* case(1) or by the various Lords, especially Lord Parker, in *Usher's* case(2). The Rules do certainly present a curious example of draftsmanship. The governing principle, however, is that the assessment is to be on the balance of the profits and gains. Rule 1 provides that the tax shall be charged without any deduction other than is by the Act allowed. Rule 3 (*a*) is the most general in its terms: " . . . . no sum shall be deducted in respect of —(*a*) any " disbursements or expenses, not being money wholly and exclu- " sively laid out or expended for the purposes of the trade, " profession, employment, or vocation ". One major question debated both in *Russell's* case and *Usher's* case was whether there could be a deductible expense when there was no outlay in money, but merely the sacrifice or surrender of something of value wholly for the purpose of the trade. This was true of the rent of the manager's residence in *Russell* where the whole rent was forgone, and of the rent in *Usher's* case where only a part was forgone. The decision was in both cases that the money value of the rent forgone was deductible, and that in *Usher's* case the partial payment made no difference, save that the amount deductible had to be reduced *pro tanto*. Lord Herschell (13 App. Cas., at page 425(3)), after examining the Rules, thus concluded: " The annual value " (of the premises occupied by the bank manager) " is, therefore, to be deducted somehow. It is to " be deducted either by taking it as an element before arriving at " the balance of profits and gains, or as included in a very broad " construction of the provision relating to disbursements and " expenses ". Lord Herschell means in that phrase that there is a disbursement or expense within the Rule though not in a literal sense, since money has not been expended. In *Usher's* case, Lord Parker arrived, at page 460 of [1915] A.C.(4), at a similar conclusion. He dealt with the prohibition against any deduction for the rent or value of a dwelling-house except such part as is used for the trade, and pointed out that the Rule refers only to a dwelling-house occupied by the person to be assessed. He summed up the position thus: " In other words, the effect of the prohibition " cannot be extended by implication to cover a deduction for rent " or annual value which would otherwise be a proper deduction in " ascertaining the balance of profits and gains ". He stated his general view of the law on this point at page 458(5): " The better " view, however, appears to be that, where a deduction is proper " and necessary to be made in order to ascertain the balance

(1) 2 T.C. 321. (2) 6 T.C. 399. (3) 2 T.C. 321, at p. 328.
(4) 6 T.C., at p. 430. (5) *Ibid.*, at p. 429.

(Lord Wright.)

" of profits and gains, it ought to be allowed, notwith-
" standing anything in the first rule or in section 159,"
(of the Act of 1842) " provided there is no prohibition
" against such an allowance in any of the subsequent rules applicable
" to the case ". In my opinion, Lord Parker was clearly deciding the case on general principles, not on any particular feature attaching to rent or annual value. Lord Sumner expressed this view quite specifically in the passage I have quoted(1). Lord Loreburn's reference to " sound commercial outlay "(2) again put the principle. So also did Lord Atkinson in the passage I have quoted(3). The particular analogy he drew between the manager's salary and the reduced amount of rent shows that he was enunciating a general principle.

In *Hoare and Co., Ltd.* v. *Collyer*, [1932] A.C. 407(4), the principle in *Usher's* case was considered by this House, the issue being whether the loss by brewers on the lettings of some tied houses could be set off against the profit on others. This House decided against such aggregation of gains and losses. But all their Lordships summed up the effect of *Usher's* case in substantially the same terms. I shall quote the language of Lord Atkin at page 416(5): " Whether the expense allowed in *Usher's* case is
" based upon a deduction of the Schedule A valuation as on premises
" used in the brewers' business, mitigated by the sum received from
" the tied tenant, or whether it is regarded as a notional sum paid
" for the advantage of the tie, it is allowed as an expense incident
" to the particular house in respect of which it is incurred. It in
" no way differs from expenses for repairs or compensation levy or
" insurance premiums on particular houses such as are also author-
" ised by the same decision ". Lord Tomlin, at page 419(6), said:
" In *Usher's Wiltshire Brewery, Ltd.* v. *Bruce*, where tied houses
" of a brewery company were held by the tenants at rents below
" the Schedule A valuations, your Lordships' House, as I under-
" stand the case, treated the difference between the rent and the
" valuation in the case of each house as rent forgone, or money
" spent exclusively for the purpose of earning profits, and held that
" expense to be one which could be deducted for the purpose of
" ascertaining profits and gains under Schedule D ". The other Lords who took part in the appeal spoke to the same effect. It is difficult to see what Schedule A has to do with this kind of question, except as fixing the limit of annual value. Schedule A deals with the assessment of the charge on the landholder. The deductions now being considered are deductions under Schedule D in respect not of landowning but of a trade or business. The two Schedules are disparate and distinct.

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(1) 6 T.C., at p. 437. (2) *Ibid.*, at p. 420. (3) *Ibid.*, at p. 428.
(4) 17 T.C. 169. (5) *Ibid.*, at p. 213. (6) *Ibid.*, at p. 215.

(Lord Wright.)

One other case I must refer to, that of *Weight* v. *Salmon*, 51 T.L.R. 333(1). I regard that case as the counterpart of the present, though it is not a direct authority because the question there turned on the different language of Schedule E. It dealt with the position of the recipient, not the payer. The company there had allotted shares to its directors at par, which was considerably below their market value. As the allotment was found to be by way of extra remuneration for their services, it was held that the directors (or at least the director who was concerned in the case) were taxable in respect of the value of that remuneration under Rule 1 of Schedule E. Lord Atkin, in whose speech the other Lords concurred, said(2) that the difference between the price paid and the value of the shares was an immediate profit in the nature of money's worth, and put as an analogy a case where a director of a colliery company himself engaged in the coal trade was given the privilege of buying coals at one-third of their market price. That would clearly be a profit or perquisite of the office. But as the Master of the Rolls observed in the judgment appealed from, it would be a startling inconsistency to say that the director was to be taxed because he was receiving by way of remuneration money's worth at the expense of the company and yet that the company which was incurring the expense for the purposes of its trade to remunerate the directors was not entitled to deduct that expense in ascertaining the balance of its profits and gains, whether the matter is dealt with as an expense under the specific Rules applicable to Cases I and II under Schedule D, a course which would be justified by the opinions expressed in *Usher's* case(3), or alternatively under the general right to deduct expenses according to the ordinary principles of commercial trading.

Now it is true that in certain cases an employee who has received a benefit from his employment may not be assessable in regard to the value of it. Thus in *Tennant* v. *Smith*, [1892] A.C. 150(4), a bank manager or agent, who was in the same position as the manager or agent in *Russell's* case(5) was held not to be assessable in respect of the privilege of free residence, in particular because he was not free to dispose of that advantage or turn it into cash. Schedule E, said Lord Macnaghten at page 163(6), " extends " only to money payment or payments convertible into money ", or in Lord Watson's words, at page 159(7) : "money—or that which " can be turned to pecuniary account ". The decision of this House in *Weight's* case clearly involves that the acquisition by the recipient of the shares involved a benefit convertible into money, that is, to the extent of the difference between the par value and the market value. It seems to follow that an equal sacrifice expressible

(1) 19 T.C. 174. (2) *Ibid.*, at p. 193. (3) 6 T.C. 399.
(4) 3 T.C. 158. (5) 2 T.C. 321. (6) 3 T.C., at p. 170.
(7) *Ibid.*, at p. 167.

(Lord Wright.)

in terms of money must have been suffered by the Respondents. To that extent *Weight's* case(1) directly supports the Respondents' case.

It was, however, contended that though the employee may profit, the Company is at no expense and is not out of pocket when it issues shares at par, by way of remuneration or for a special purpose in the interest of its business, because the Company is involved in no expense since to allot shares at par, instead of at their market value, costs the Company nothing. It is true that the directors would not be breaking any provision of the Companies Acts if they allotted shares at par instead of realising their market value. They might do so for some legitimate reason, for instance, to give a bonus to the extent of the price difference to shareholders, or to remunerate employees, or to discharge a debt of any kind. Otherwise the shareholders might complain that by so issuing shares at less than the market value, the directors were wasting the assets of the Company, if they were not getting something in return or had no good reason for so doing or at least did not *bona fide* think they had. It is, however, said that shares are not an asset of the Company. I agree, as I have already observed, that unissued shares are not an asset of the Company: But in Lord Davey's useful phrase in *Hilder* v. *Dexter*, [1902] A.C. 474, at page 480, they are potential capital. The company which has the right to issue them has a right which it can turn into money, and the amount of money which it can derive from the issue depends on the market. The question is not what the shares cost the company, but what they were worth to the company in the sense that it was open to the company to derive the full market value, either by selling on the market or by allotting at an undervalue as fully paid shares for some special consideration or object in the company's interest. No one, I imagine, would deny that if the Company had been possessed of bonus shares in a subsidiary company, which had cost them nothing, the value to them of these shares was their market value, and that if the Company used these shares to pay a debt or satisfy an obligation in the course of the Company's trading, their value could be deducted in ascertaining the balance of profits and gains. I see no difference in principle between that case and the present.

Hilder v. *Dexter* in my opinion either does not throw any light on the question whether in this case the Company has incurred an expense, or perhaps, more accurately, supports my view, for the reason which I stated in citing it above. The sole question there was whether an allotment of shares at par fell, on the facts of the case, within Section 8, Sub-section (2), of the Companies Act, 1900, which prohibited a company from applying either directly or

(1) 19 T.C. 174.

(Lord Wright.)

indirectly any of its " shares or capital money " to the payment of commissions and similar matters, save as provided in the Act. A shareholder who had taken up shares did so on the terms of an agreement that he should have the option at a later date of taking up a certain number of shares at par. He exercised the option when the market price was above par. The company fulfilled its contract and it was held that the Section was not contravened. Lord Davey, at page 480, construed the words " shares or "capital money" as meaning "its capital, either in the form of shares " before issue, when they may be described as potential capital, " or in the form of money derived from the issue of its shares ". He concluded : " But the point which, in my opinion, is alone " material for the present purpose is that the benefit to the share- " holder from being able to sell his shares at a premium is not " obtained by him at the expense of the company's capital ". This, in my opinion, is merely a decision on the particular words of the Act and affords no guidance in this appeal. Indeed it seems clear that in the events which happened the capital was not being reduced nor had there been any outlay of money, capital or otherwise, by the company, nor any application of shares or capital money to the payment of commission and so forth. The company was simply fulfilling its contract. The words of the Act are narrow.

I must not be taken to say that a profit forgone is in every case the same as an outgoing or expense, or that money's worth is always to be deemed to be the same as money. But I think that in the facts of the present case and for purposes of determining the deductions permissible for the Respondents under Schedule D both propositions may be asserted.

For all these reasons, which in substance are the same as those stated by the Master of the Rolls in the Court of Appeal, I think that the decision of the Court of Appeal was right. I regret that I find myself unable to agree with those of your Lordships who are of a different opinion.

Lord Romer.—My Lords, the findings of fact in this case by the Commissioners for the General Purposes of the Income Tax for the City of London are not as clear as could be wished upon the question of what was the object of the directors in making the allotment of shares to the employees of the Respondent Company. In paragraph 2 of the Case Stated the shares are said to have been allotted as " remuneration for services ". So, too, in paragraph 10. In paragraph 13, which sets out the contentions of the Company, the difference between the par value and the market value of the shares is alleged to represent remuneration for the services of the employees, and no exception to this allegation

(Lord Romer.)

appears to have been taken by the Appellant in his contentions as they are set out in paragraph 14. Now, that one of the objects of the directors in making the allotments was to remunerate certain of the Company's employees for past services is made apparent by the directors' letter of the 15th June, 1934. " The Directors," says the letter, " desire to show their appreciation of special " services you have rendered to the Company, by giving you an " opportunity to acquire a share interest in the Company on " favourable terms ". It is plain, however, that there was much more in it than this. In paragraph 12 of the Case, the Commissioners refer to the evidence given by the secretary of the Company, evidence which the Commissioners must be taken to have accepted as true. It included the following statement : " The offer of shares " made by the directors to the employees was solely in the interests " of the Respondent's trade ", a statement that would hardly be made about an offer of shares merely in recognition of past services. It was, however, obviously in the interests of the Company's trade that its employees should, by becoming shareholders, acquire an incentive to promote the success of the Company, and the directors seem to have realised that, if the employees were to become shareholders, it would be advisable to offer them some inducement to do so. Hence the reference in the letter to the " favourable terms " offered to the employees in allowing them to take up the shares at par. If the shares were being offered merely in recognition of past services, it would be a matter of indifference to the Company or its directors whether the employees accepted the offer or not. One does not usually hold out inducements to a person to persuade him to accept a present.

In these circumstances the proper conclusion to be drawn from the facts set out in the Stated Case seems to me to be this : that in order to induce some of its employees to take up shares in the Company the directors, in the interests of the Company's trade, offered such employees at 5*s*. per share 6,000 of its shares for which the directors could have obtained £2 3*s*. 9*d*. each from the public had they wished to do so. That such a transaction would have involved no breach of Section 45 of the Companies Act, 1929, is plain. The Company would not have applied any of its shares or capital money either directly or indirectly in consideration of the employees' subscription for the 6,000 shares (see as to this *Hilder* v. *Dexter*, [1902] A.C. 474).

But the question to be decided upon this appeal is whether, in computing its profits for Income Tax purposes, the Company is entitled to deduct an amount representing the difference between the par value and the market value of the 6,000 shares, that being the benefit which accrued to the employees as consideration for their subscribing for the shares.

(Lord Romer.)

That the question is one of considerable difficulty is apparent from the fact that it has given rise to a difference of opinion between the Courts below and also between the members of this House. But, having given the matter my anxious consideration, I have formed a very clear opinion that the question should be answered in the affirmative.

My Lords, it has been laid down on more than one occasion by this House that, in order to ascertain whether, in computing the profits of a trade for the purposes of Schedule D, Case I, of the Income Tax Act, a particular deduction is permissible, the profits must be ascertained on ordinary commercial principles by setting against the income earned what it has cost to earn it, provided always that as regards each particular item of cost, its deduction is not expressly prohibited by the terms of the Act and Rules. It becomes necessary, therefore, to inquire in the present case whether, in ascertaining the profits of its trade on ordinary commercial principles, it would be permissible to deduct the sum in question as forming part of the cost of earning the Company's income.

It must, of course, be conceded that the sum never formed part of the assets of the Company. It was, nevertheless, a sum that could have been made an asset had the directors decided to issue the 6,000 shares to the public at the market price. The Company, therefore, had the power of acquiring such a sum. I have never consciously committed, and I trust that I may never commit, the great sin in a lawyer's eyes of confusing property with power. If a man has a general power of appointment over a sum of money, the sum does not strictly speaking form part of his assets. Should he release the power voluntarily, his assets will be in no way diminished. He will not have parted with a farthing. But he will nevertheless be the poorer for having released the power. So too in the case of a company whose shares stand at a premium in the market. The directors may, if they think fit, and if they act in good faith, issue the shares at par. In such a case they in effect voluntarily release the power of the company to acquire the premium. The company parts with none of its money, but it is nevertheless the poorer for the release. For not only does the company give up by the release the opportunity of adding to its assets a sum in cash, it also gives up the opportunity of utilising the possession of the power for the purpose of adding directly to its stock-in-trade, or for the purpose of preventing a diminution of its existing assets. Where a company issues its shares at a premium, the premium is a receipt on capital account. It is not a trading profit and it is not chargeable with Income Tax. It can, nevertheless, be distributed as dividend among the shareholders, or spent in purchasing stock or machinery, or in any other way that the company thinks fit. But the company may equally

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well utilise its power of realising the premium by purchasing (say) stock-in-trade, or by discharging a liability without any cash passing through its hands at all. If a company, for example, whose £1 shares stand at 10 per cent. premium in the market buys goods of the value of £110 by the issue of 100 fully paid shares to the vendor, the cost price of the goods to the company is £110. If it then sells the goods for £130, its trading profit from the transaction (apart from working charges which can be disregarded) will be £20 and not £30. It will have made a total profit on the transaction of £30, but £10 of this, representing the premium, will be entered as a receipt on capital account. The £20 alone will be taxable.

A company, too, in the like circumstances, may discharge an existing trading liability of £100 by the issue to its creditor of 1,000 shares for a payment of £1,000. It will not have parted with the £100, but it will have utilised the power of realising the £100 premium by preventing its assets being depleted by that amount. The £100 will accordingly be deducted from the trading account, *pro tanto* diminishing the taxable trading profit, and a similar amount must be credited in the books as a receipt on capital account.

It is to be observed in both these cases that, if the premium could be treated as a trading and taxable receipt, there would be no necessity to resort to this method of book-keeping. In the first instance, the cost of the goods could be entered as being £100 only, and in the second instance nothing would be deducted in respect of the debt; and nothing in either case would be credited in respect of the premium. It is the fact that the premium is not a trading and taxable receipt that renders this " short-circuiting " impossible.

Applying these considerations to the present case, it is obvious that the directors have utilised the possession of the power of realising a premium of £1 18*s*. 9*d*. on each of the 6,000 shares for the purpose of inducing their employees to subscribe at par for those shares and so become members of the Company. It is found that this was done solely in the interests of the Company's trade, which means that it was done solely for the purpose of enabling the Company to earn its income. In these circumstances, I should, but for the fact that some of your Lordships are of the contrary opinion, have thought it plain that in ascertaining the trading profits of the Company on commercial principles the deduction now sought to be made was permissible as part of the cost of earning the Company's income, a like sum being, of course, credited to its capital account.

It may be convenient at this stage to say something about a passage in the judgment of the Master of the Rolls in the present case that has been the subject of much misunderstanding. The

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passage in question is as follows(1) : " If an employer having two " receptacles, one containing cash and the other containing goods, " chooses to remunerate his employee by giving him goods out " of the goods receptacle instead of cash out of the cash receptacle, " the expenditure that he makes is the value of those goods, not " their purchase price or anything else, but their value, and that " is the amount which he is entitled to deduct for Income Tax " purposes ". It seems to have been thought that the Master of the Rolls was here suggesting that, for the purpose of ascertaining the profits of the employer's business made by the purchase and sale of such goods, the cost of the goods to the employer was to be treated as their sale value. The Master of the Rolls, of course, said nothing so absurd. If an employer, having bought 100 tons of coal at 20*s*. per ton and having incurred no other expense than £10 10*s*. paid in cash to his clerk for salary, sells the coal for 30*s*. per ton, the profit of his trade is £39 10*s*. If, however, instead of paying the clerk in cash, he pays him by handing over to him 7 tons of coal worth 30*s*. a ton, and sells the remaining 93 tons at 30*s*. per ton, the result to the trader will obviously be the same as in the first case. But the amount that he will enter in his accounts in respect of the salary of his clerk will depend upon the way in which he chooses to keep his books. He may, if he likes, treat the 7 tons as having been sold to the clerk at 30*s*. a ton. In that case he will deduct £10 10*s*., the value of the 7 tons, as an expense in respect of the clerk's salary. In this case, however, the sum that would have been realised had the 7 tons been sold at 30*s*. would have to be treated as a trading receipt. The employer could, therefore, and no doubt would, " short-circuit " the account by crediting himself with nothing in respect of the 7 tons and debiting nothing in respect of the salary. I have taken this example as it was one that the Solicitor-General placed before your Lordships for the purpose of showing that, in such a case as last supposed, no deduction could be made in respect of the clerk's salary. But the Solicitor-General was assuming that the employer " short- " circuited " the account. No further deduction could be made in that case in respect of the salary, for it would have already been deducted in account. The Master of the Rolls, on the other hand, was obviously assuming that the employer used the longer, and perhaps more accurate, way of keeping his accounts. In that case the value of the 7 tons of coal would properly be deducted as an expense, for the employer would have credited himself with that value as a trade receipt. The Master of the Rolls no doubt thought it was unnecessary to say so, and so it was.

Having arrived at the conclusion that the deductions in the present case would on commercial principles be permissible as part

(1) *See* page 270 *ante*.

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of the cost of earning the Company's income, I must now inquire whether such a deduction is expressly prohibited by the Income Tax Act and Rules. I can deal with this matter quite shortly. The only Rule that by any possibility can be regarded as prohibiting the deduction is Rule 3 (*a*) of the Rules applicable to Cases I and II of Schedule D. But if the sum now in question is to be regarded as a disbursement or expense at all, it can only be done by treating the Company by a stretch of the imagination as having received the sum and passed it on to the employees. In that case, however, the sum must be treated as money, and, as it would have been wholly and exclusively laid out or expended for the purposes of the trade, the deduction is not prohibited.

I should, therefore, have arrived at the conclusion that the deduction in question is permissible, even if there were no authority to be found in the books to lend support to that conclusion. There are, however, at least two decisions of your Lordships' House which appear to me to be direct authorities in favour of the view that I have endeavoured to express. They are *Russell* v. *Town and County Bank, Ltd.*, 13 App. Cas. 418[1], and *Usher's Wiltshire Brewery, Ltd.* v. *Bruce*, [1915] A.C. 433[2]. The facts in the first of these two cases, decided under the Income Tax Act, 1842, were as follows. A company carrying on the business of banking were the owners of the premises upon which the business was carried on, and those premises contained certain accommodation occupied as a dwelling-house by the manager of the bank. The company claimed to deduct, in estimating the balance of their profits and gains under Schedule D, the entire annual value of the bank premises, including the portion so occupied by the manager. The Crown, on the other hand, contended that the portion of the premises occupied for that purpose ought to be dealt with separately from the part used for the actual carrying on of the business and that no deduction ought to be allowed in respect of the annual value of the portion occupied by the manager as a dwelling-house. The point at issue, therefore, was, in effect, whether the deduction of this last-mentioned annual value was not forbidden by what at that time corresponded to the present Rule 3 (*c*), it being admitted by the Crown that the annual value —that is, the rent which the company might have received for the bank premises proper had they let the premises to a tenant—was a proper deduction. This admission was held by Lord Herschell to have been rightly made. He said this (page 425[3]) : " Now " it is not disputed that the annual value of premises exclusively " used for business purposes is properly to be deducted in arriving " at the balance of profits and gains. I am, of course, speaking, " for the moment, of premises which are not used in any way

(1) 2 T.C. 321. (2) 6 T.C. 399. (3) 2 T.C., at p. 327.

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" as a place of dwelling, but are exclusively business premises. " But there may be a question where the right to make that " deduction is to be found. I am myself disposed to think that it " is allowed because it is an essential element to be taken into " account in ascertaining the amount of the balance of profits. If " not it can only be included by a very broad extension of the " terms actually used, as being a disbursement or expense which " is money wholly and exclusively laid out or expended for the " purposes of the trade ". He then referred to the exception contained in the predecessor of Rule 3 (*c*) (which was substantially the same as the exception contained in Rule 3 (*c*)) but, as I read his judgment, merely as being confirmatory of the conclusion he had reached without that exception. If he had thought that the exception was itself an enactment impliedly justifying the deduction, he would have said so, and would not have given other reasons for arriving at his conclusion, which seems to be based on quite general principles. The annual value of the part occupied by the manager was also allowed as a deduction, it being held that the part so occupied was not a dwelling-house within the Rule. Lord FitzGerald also based his decision on general principles relating to the ascertainment of profits, and made no reference at all to the Rule relating to dwelling-houses. He said this (page 429(1)): " ' Profits ' I read on authority to " be the whole of the incomings of a concern after deducting " the whole of the expenses of earning them—that " is, what is gained by the trade. The whole expenses of earning " them must mean, according to the schedule, the whole expenses " incurred for the purposes of the business and nothing else. But " I come, upon the statement of facts, to the conclusion that " . . . . the whole premises were used for the purposes of the " business of the bank and the annual value of them forms a " proper deduction in estimating the balance of profits. . . . That " balance of profits is to be ascertained after deducting the whole " of the necessary expenses save those which by negative provisions " are excepted in the statute ". Lord Macnaghten said (page 430(1)) that the deduction was " properly and necessarily " made in estimating the profits and gains of the bank which were " chargeable with duty ", and that there was nothing in the Rules applicable to Cases I and II under Schedule D prohibiting the deduction. He did not think that the house was a dwelling-house within the meaning of the Rules. I would call attention to the word " necessarily " used by Lord Macnaghten.

I regard this case as a clear authority for the proposition that in computing the profits of a trade for Income Tax purposes a sum may be deducted as part of the cost of earning the receipts

(1) 2 T.C., at p. 331.

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which has never in fact been paid or expended, but is something the receipt of which has been forgone for the purpose of the trade. In the particular case the company refrained from letting their premises, and so earning a profit, solely in the interests of their business. It was, therefore, proper and necessary on ordinary commercial principles to deduct from their receipts this profit that they might have made as part of the cost of earning such receipts, and there was nothing in the Act to render such deduction illegal.

My Lords, *Usher's* case[1] is, as I read it, another authority for the same proposition. The facts of that case are so familiar to your Lordships that I will not weary you with reciting them. It is sufficient to recall that the brewery company sought to deduct (amongst other things) the difference between the annual value in the case of freehold and the rent they paid in respect of leasehold houses on the one hand, and the rent received from their tied tenants on the other. Your Lordships are also familiar with the reasons given by this House for deciding that the actual cash disbursements made by the company in connection with the tied houses were allowable deductions upon ordinary commercial principles and not prohibited by the Income Tax Acts then in force. But the important thing to be noticed for the present purpose is that none of their Lordships who were parties to the decision drew any distinction between the freehold and leasehold properties, that is to say, between the rents paid for the leaseholds and the annual values of the freeholds. Both the annual values in the case of the freeholds and the rents paid in the case of the leaseholds were treated as forming part of the cost of the brewery business and for precisely the same reason, namely, that both the rents paid for the leasehold properties and the rents that would have been received for the freeholds had they been let, instead of being used for the business, formed part of the costs incurred in earning the receipts of the business, and that the deduction of them was not prohibited by the Act. Lord Loreburn, referring to both classes of property together, said (page 446[2]): "On ordinary "principles of commercial trading such loss arising from letting "tied houses at reduced rents is obviously a sound commercial "outlay". Lord Atkinson, in holding that it was immaterial whether a manager or a tied tenant was put into occupation of the houses, said (page 457[3]): "Part of the cost to the brewer "is, in the manager's case, his salary, and possibly a discount on "profits. In the case of the tenant it is the difference between "the annual value of his, the brewer's, freehold house and the "rent he receives for it, and in his leasehold house the difference "between the rent he receives for it and the rent he pays for it, "if that be equal to the full annual value under Sched. A. For

(1) 6 T.C. 399. (2) *Ibid.*, at p. 420. (3) *Ibid.*, at p. 428.

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" for the purposes of striking the balance of profits and gains the " two cases are in principle undistinguishable ". Lord Parker said (page 463(1)) : " The appellants claim to deduct, in the one case, " the difference between the Sched. A assessment and the rent " they receive, and in the other case the difference between the " rent they pay and the rent they receive. In other words, they " claim the Sched. A assessment value or the rent they pay as a " deduction, giving credit on the other side of the account for " the rent paid by the tenants of the tied houses. I am of opinion " that they are also right in this contention ". Lord Sumner dealt even more particularly with this absence of difference, for the purpose of estimating the costs of a business, between sums actually spent and sums that might have been received but were forgone for the purposes of the business. " Next as to the rent," he said (on page 469(2)), " A trader who utilizes, for the purposes " of his trade, something belonging to him, be it chattel or real " property, which he could otherwise let for money, seems to me " to put himself to an expense for the purposes of his trade. " Equally he does so if he hires or rents for that purpose property " belonging to another." These observations exactly apply to the present case, if, as I have endeavoured to show in an earlier part of this judgment, there can be no difference in principle between utilizing property and utilizing a power for the purposes of a business.

It is plain from the passage that I have just cited from Lord Sumner's judgment that, in deciding in favour of the deduction of the annual values of the freeholds, he was not relying in the least upon any consideration peculiar to land or houses, or upon any implication that was to be drawn from the Rule now represented by Rule 3 (*c*). Nor did the other noble Lords. It appears, moreover, that neither Lord Atkinson nor Lord Parker, who were the only ones who referred to *Russell's* case(3), regarded that case as depending upon any such consideration. Lord Atkinson said(4) that the decision in that case was obviously right and just, because, if the trader abstains from letting his premises and devotes them to the purposes of his trade, he must be taken to have dedicated to that trade a sum equivalent to the annual sum which he might have obtained in the shape of rent if he had let them to an untied tenant. Lord Parker enumerated three points which he said had been decided in *Russell's* case. Of these I need only mention the second, because that one alone dealt with the prohibition of deductions in respect of the annual value or rent of dwelling-houses. He said this(5) : " Secondly, it decides that the rule refers

(1) 6 T.C., at p. 432. (2) *Ibid.*, at p. 437. (3) 2 T.C. 321.
(4) 6 T.C., at p. 425. (5) *Ibid.*, at pp. 430/1.

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" only to a dwelling-house or domestic offices, or part of a dwelling-
" house or domestic offices, occupied by the person to be assessed;
" so that the fact that a bank manager resides in part of the bank
" premises does not bring that part of the premises within the
" prohibition or prevent the whole premises from being considered
" as used for the purposes of the trade ". Now observe what follows(1): " In other words, the effect of the prohibition cannot be
" extended by implication to cover a deduction for rent or annual
" value which would otherwise be a proper deduction in ascertain-
" ing the balance of profits and gains ". It is not that the Rule permits the deduction by implication of the annual value or rent of a house that is not a dwelling-house. The point is that the Rule does not prohibit that deduction, which is a proper one to be made on commercial principles.

My Lords, for these reasons, I would dismiss this appeal.

Questions put:

That the Order appealed from be reversed except as to costs

The Contents have it.

That the judgment of Macnaghten, J., be restored except as to costs, and that pursuant to the terms on which leave to appeal to this House was granted, the Appellant do pay to the Respondents their costs in this House.

The Contents have it.

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

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(1) 6 T.C., at p. 431.

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