NO. 1297—HIGH COURT OF JUSTICE (KING'S BENCH DIVISION)—
14TH AND 15TH MAY, 1942

COURT OF APPEAL—23RD, 24TH, 25TH AND 26TH FEBRUARY, AND
20TH APRIL, 1943

HOUSE OF LORDS—14TH, 15TH, 16TH, 17TH, 21ST, 23RD, 24TH AND
28TH FEBRUARY, AND 19TH MAY, 1944

ABSALOM v. TALBOT (H.M. INSPECTOR OF TAXES) [1]

Income Tax, Schedule D—Profits of trade—Sales of houses by builder—Part purchase price advanced by building society—Whether balance, secured by second mortgage granted by builder, to be brought in as trading receipt in year of sale.

The Appellant carried on the business of a speculative builder erecting workmen's houses for sale. In most cases the purchasers, being unable to find the whole purchase price, paid a small deposit only. The bulk of the remainder of the purchase money was advanced on first mortgage by a building society and the Appellant advanced the balance on the security of a second mortgage with the addition in some cases of a promissory note.

On appeal against assessments to Income Tax under Case I *of Schedule D, the Appellant contended that the sums receivable under the second mortgages and promissory notes should be valued at their actual value at the time of the sale of the houses, and that if a valuation were impracticable the amounts assessable in any year were only the advances repaid in that year. The Special Commissioners decided that, on the granting of a second mortgage or promissory note, a trade debt due from the purchaser to the Appellant was created, the amount of which must be included as a receipt in the computation of his liability to Income Tax for the year in which the sale took place.*

Held *(the Lord Chancellor and Lord Porter dissenting), that the sums receivable under the second mortgages and promissory notes should be taken into account at the time of the sale of the houses at their estimated value at that time, and not at their face value.*

CASE

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

1. At a meeting of the Commissioners for the Special Purposes of the Income Tax Acts held on 5th February, 1941, F. R. Absalom (hereinafter called "the Appellant") appealed against four assessments to Income Tax in the sums of £87,000, £48,000, £24,000 and £30,000 for the years ending 5th April, 1935, to 5th April, 1938, inclusive, made upon him under the provisions of Case I of Schedule D of the Income Tax Act, 1918.

2. The Appellant carried on the business of a speculative builder during all times material to this appeal. He retired on 31st December, 1937. His business mainly consisted of erecting workmen's houses at Erith and Bexley Heath, after purchasing the land and making the necessary roads and sewers. The purchase price of the houses ranged from £395 to £750.

[1] Reported (K.B.) [1942] 2 All E.R. 269; (C.A.) [1943] 1 All E.R. 589; (H.L.) [1944] A.C. 204.

3. In most cases, the purchasers being unable to find for themselves the purchase price of the houses, paid a small sum down (varying between £20 and £35) and the balance was advanced on mortgage by a building society under guarantee by the Appellant of a proportion of the amount so advanced. The Appellant became dissatisfied with this method because of his liability under the guarantee to the building society. He adopted a system of granting second mortgages and in some cases accepting promissory notes in respect of the difference between the sale price of the house and an amount made up of the cash deposit and the amount advanced on first mortgage by the building society.

4. This latter method was adopted by the Appellant at all times material to this appeal and consisted of a cash deposit being paid by the purchaser of the house at the time of reservation, and a second mortgage (with or without a promissory note) being usually executed at the same time as the conveyance to the purchaser and the first mortgage to the building society.

A copy of a completion statement in the case of J. Mayhew, a conveyance and second mortgage to the same, marked " A ", " B " and " C ", respectively, are annexed hereto and form part of this Case, as examples[1].

A copy of a completion statement in the case of W. Hearnden, a second mortgage and promissory note, marked " D ", " E " and " F ", respectively, are annexed hereto and form part of this Case, as examples[1].

A summary of second mortgages and promissory notes, shewing the balance outstanding at the end of 1936, is annexed hereto, marked " G ", and forms part of this Case[1].

5. The Appellant gave evidence at the hearing before us which we accepted, as follows :—

> He never wrote off debts as bad until it was known that the building society had sold the house in question under its powers. Up to 1935 he had occasionally sued on the covenant in the second mortgage granted by him, but he had then given it up as useless. He had also tried debt collectors but the purchasers were not worth pursuing.

6. Copies of the Appellant's accounts for the years ending 31st December, 1933 and 1937, are annexed hereto, marked " H " and " I ", respectively, and form part of this Case[1].

7. Mr. H. C. Hopkin, incorporated accountant, gave evidence at the hearing before us which we accepted, as follows :—

> He had prepared the Appellant's accounts for some years past. All the accounts from 1933 up to 1936 had been prepared on identical lines. The certificate of his firm on the balance sheet for 1933 was an unqualified one. In this, second mortgages were included on the assets side of the account in sundry debtors. The figure of sales in the profit and loss account included the nominal amount of second mortgages and promissory notes. The Respondent had in every year allowed a deduction for debts (secured by second mortgages or promissory notes) proved to be bad, and the amounts of these deductions are agreed subject to the question of principle at issue. After the decision in *John Cronk & Sons, Ltd.* v. *Harrison*, 20 T.C. 612, he wished to reopen the accounts.

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

(*a*) That the sums receivable under the second mortgages or the promissory notes fell to be valued, at the time of the sale of the houses, at their actual value at that time and not at their face value.

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[1] Not included in the present print.

(*b*) That, if a valuation be found to be impracticable, then the sums received under the second mortgages or the promissory notes are assessable as trading receipts in the trading years in which they are received.

(*c*) That Rule 3 (*i*) of the Rules applicable to Cases I and II of Schedule D is a Rule applicable to normal commercial or trading transactions for cash. It never was part of the arrangement between the Appellant and a purchaser (in the type of case in question) that the Appellant was entitled to payment of the whole price at the time of sale.

(*d*) That the acknowledgement of receipt of the whole price in the deed of conveyance was conclusive in favour of a purchaser for value without notice, and was necessary to give a good title, but did not prevent the true facts being regarded in such a question as the present one (cf. Lord Thankerton in *John Cronk & Sons, Ltd.* v. *Harrison*, 20 T.C., at page 641).

(*e*) That in receiving a second mortgage the Appellant received a thing which may be of money's worth, but he did not thereby receive payment of the purchase price. Further, in respect of the promissory notes, the general principle applies that " a debtor who " gives his creditor a promissory note for the sum he owes can in no " sense be said to pay his creditor : he merely gives him a document " or voucher of debt possessing certain legal attributes "—vide *Commissioner of Income Tax* v. *Maharajadhiraja of Darbhanga*, 60 I.A. 146, at page 161, and *Cross* v. *London and Provincial Trust, Ltd.*, 21 T.C. 705, at pages 716/8.

(*f*) That the present case is concluded in principle by the decision of the House of Lords in *John Cronk & Sons, Ltd.* v. *Harrison*, and the fact that in that case the primary question lay between the builder and the building society does not differentiate it from the present case since " it is clear that as regards the balance of the " price the building society acted as the agent of the purchaser "—vide Lord Thankerton, 20 T.C., at page 641.

9. It was contended on behalf of the Respondent, the Inspector of Taxes :—

(1) That the Appellant in the course of his trade made sales on credit.

(2) That the amounts owing to the Appellant secured by second mortgages or promissory notes were trade debts, the amount of which must be brought into account except in so far as a deduction was permissible in respect of bad or doubtful debts under the provisions of Rule 3 (*i*) of the Rules applicable to Cases I and II of Schedule D.

(3) That the Appellant was claiming, in effect, an allowance for anticipated future losses to which he was not entitled.

(4) That the case of *John Cronk & Sons, Ltd.* v. *Harrison*, 20 T.C. 612, was distinguishable.

(5) That the assessments were correct in principle and should be confirmed.

10. We, the Commissioners, held that on the granting of a second mortgage or promissory note to the purchaser of the Appellant's houses a trade debt, due from the purchaser to the Appellant, was created and that in computing his liability to Income Tax it must be included. These debts, if and when proved to be bad, would be allowable as deductions in the normal manner. Reliance was placed by the Appellant on the case of *John Cronk & Sons, Ltd.* v. *Harrison*, 20 T.C. 612. In our opinion in that case no debt was due from the

purchaser of the houses, the question lay between the builder and the building society. In our view the present case is one of sale of houses on credit, and trade debts were created in respect of the purchase price by way of second mortgages and promissory notes.

We held that the appeal failed and we confirmed the assessments in the following figures agreed between the parties, namely:—

1934–35	..	£82,896, less £176 for wear and tear.
1935–36	..	£44,521, less £230 for wear and tear.
1936–37	..	£15,490, less £167 for wear and tear.
1937–38	..	Nil.

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

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

Turnstile House,
94/99 High Holborn,
London, W.C.1.
16th October, 1941.

The case came before Macnaghten, J., in the King's Bench Division on 14th and 15th May, 1942, and on the latter date judgment was given in favour of the Crown, with costs.

Mr. Cyril L. King, K.C., and Mr. J. H. Bowe appeared as Counsel for the Appellant, and the Solicitor-General (Sir David Maxwell Fyfe, K.C.) and Mr. Reginald P. Hills for the Crown.

JUDGMENT

Macnaghten, J.—In this case the Appellant, F. R. Absalom, formerly carried on the business of a speculative builder. He retired from that business on 31st December, 1937. He appealed against four assessments to Income Tax in the sums of £87,000, £48,000, £24,000 and £30,000 for the years ending 5th April, 1935, to 5th April, 1938, inclusive, made upon him under the provisions of Case I of Schedule D of the Income Tax Act, 1918. His business before he retired mainly consisted of erecting workmen's houses at Erith and Bexley Heath which he sold at prices ranging from £395 to £750. On completion of a purchase the bulk of the purchase money was advanced by a building society on a first mortgage. The balance of the price, after crediting the deposit previously paid by the purchaser and the amount advanced by the building society, was secured by a second mortgage or a promissory note.

At the hearing before the Special Commissioners the Appellant gave evidence, which they accepted, as follows: that he never wrote off debts as bad until it was known that the building society had sold the house in question under its powers; that up to 1935 he had occasionally sued on the covenant in the second mortgage granted, but that he had then given it up as useless; that he had also tried debt collectors, but the defaulting purchasers were not worth pursuing.

(Macnaghten, J.)

The question at issue on the appeal is whether the amounts covered by the second mortgage or the promissory notes ought to be entered as a trade receipt in the accounts for the year of assessment in which the sale took place.

For the Appellant it was contended that the sum receivable under the second mortgage or promissory note fell to be valued at the time of the sale of the house at its actual value at that time; and if such a valuation could not be made it was assessable as a trading receipt in the year in which it was received and not in the year of the sale of the house. That contention is based upon what is said to be a principle to be found in the case of *John Cronk & Sons, Ltd.* v. *Harrison*, 20 T.C. 612.

For the Crown it was contended before the Commissioners that the amounts owing to the Appellant secured by second mortgages or promissory notes were trade debts, the amount of which must be brought into account, except in so far as any deduction was permissible in respect of bad or doubtful debts under the provisions of Rule 3 (*i*) of the Rules applicable to Cases I and II of Schedule D. The Commissioners decided in favour of the Crown, and they have expressed their decision concisely and in language upon which I cannot improve. They say: " We, the Commissioners, held that on the granting " of a second mortgage or promissory note to the purchaser of the Appellant's " houses a trade debt, due from the purchaser to the Appellant, was created " and that in computing his liability to Income Tax it must be included. " These debts, if and when proved to be bad, would be allowable as deduc- " tions in the normal manner." Then they go on to say that reliance was placed by the Appellant on *Cronk's* case and add: " In our opinion in that " case no debt was due from the purchaser of the houses, the question lay " between the builder and the building society. In our view the present case " is one of sale of houses on credit, and trade debts were created in respect of " the purchase price by way of second mortgages and promissory notes."

I think that states correctly the distinction between this case and *Cronk's* case, that in this case there was a trade debt, and in *Cronk's* case there was no trade debt at all. The fact that a trade debt is secured by a mortgage or by a promissory note, or in any other way, does not make it to cease to be a trade debt. If it is a trade debt, then the Rules under Case I must be applied. I think that the Special Commissioners were right, and the appeal must be dismissed with costs.

An appeal having been entered against the decision in the King's Bench Division, the case came before the Court of Appeal (Scott, Luxmoore and du Parcq, L.JJ.) on 23rd, 24th, 25th and 26th February, 1943, when judgment was reserved. On 20th April, 1943, judgment was given in favour of the Crown (Scott, L.J., dissenting), with costs, confirming the decision of the Court below.

Mr. Cyril L. King, K.C., and Mr. J. H. Bowe appeared as Counsel for the Appellant, and the Solicitor-General (Sir David Maxwell Fyfe, K.C.) and Mr. Reginald P. Hills for the Crown.

JUDGMENT

Scott, L.J.—The Appellant, for some years before 1933 and until 31st December, 1937, carried on the business of a speculative builder. He then retired. He was assessed under Case I of Schedule D for the years

(Scott, L.J.)

1934–35 to 1937–38 in the sums of £87,000, £48,000, £24,000 and £30,000. The assessments have been kept open for the determination of certain issues. These issues involve, directly or indirectly, important questions of Income Tax law in regard to trade debts in general, and particularly in any business the contracts in which, like those of the speculative builder, postpone for many years the final discharge of the consideration moving from the purchaser.

The Appellant's business was carried on mainly in Erith and Bexley Heath, where he bought open land, constructed roads and sewers, built houses, and then sold the freehold plots to purchasers at prices expressed in the conveyance or land transfer certificate as lump sums ranging from £395 to £750. In almost all cases the purchaser was only able to find a very small sum of money himself, varying between £20 and £35, the rest had to be found for him, directly or indirectly, by the Appellant with the assistance of a building society.

At first the Appellant used to adopt the method which the Courts had to consider for Income Tax purposes in the case of *John Cronk & Sons, Ltd.* v. *Harrison,* [1937] A.C. 185; 20 T.C. 612. There too there was a small initial payment of cash by the purchaser, but on completion there was a complex transaction in which the building society nominally found the whole of the balance, partly on first mortgage and partly on a guarantee by the builder, supported by a cash deposit from him with the society on which the society allowed him interest until the whole transaction was finally cleared after many years.

The Appellant, however, became dissatisfied with this guarantee system, apparently preferring direct relations with the man to whom he must look for ultimate performance of the obligations of the contract of sale, to the indirect pressure which he might exercise as guarantor.

His new plan, which applies to all his transactions under review in the appeal, was, as stated in the Stated Case, a " system of granting second " mortgages and in some cases accepting promissory notes in respect of the " difference between the sale price of the house and an amount made up of " the cash deposit and the amount advanced on first mortgage by the building " society."

The second mortgage and the promissory note were both executed by the purchaser at the same time as the first mortgage to the building society, at the moment of completion, when the Appellant executed the conveyance. Both mortgages provided for payment by instalments, the second mortgage over a period of some twenty-two years. The promissory note was payable by instalments over four years. All instalments were payable with interest.

The cash deposit had in each case been paid at the time the plot was reserved to the purchaser, which may have been before the house on it was even started. Copies of the conveyances, second mortgages and promissory notes are attached to the Case in two typical instances: (1) Mayhew's purchase, where there was no promissory note, and (2) Hearnden, with a promissory note.

The real effect of each system, although not the form of either, was, in my opinion, to effect part payment of the consideration in cash, that is to say to the extent of the deposit, plus the advance by the society on its first mortgage; but for the balance to create a series of fixed creditors, the purchaser being put by the contract under no obligation to pay except as and when each instalment fell due (apart from default), the vendor being content with his right as second mortgagee to enforce payment by the agreed instalments, unless the purchaser made default (including default under the first mortgage), when the whole of the balance would become payable.

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The promissory note obviously did not constitute a discharge of any existing obligation contracted by the purchaser; nor did the second mortgage under either system constitute a payment " in kind ". No money was paid and re-lent, although the documents purported to say so.

The only other facts to note are those found by the Commissioners in paragraph 5 of the Case: The Appellant " never wrote off debts as bad " until it was known that the building society had sold the house in question " under its powers. Up to 1935 he had occasionally sued on the covenant " in the second mortgage granted by him, but he had then given it up as " useless. He had also tried debt collectors but the purchasers were not worth " pursuing."

The case for the Crown is simple but far-reaching. It was based on the language of Rule 3 (*i*) of the Rules applying to Schedule D, Cases I and II:— " In computing the amount of the profits or gains to be charged, no sum " shall be deducted in respect of . . . (*i*) any debts, except bad debts proved " to be such to the satisfaction of the commissioners and doubtful debts to " the extent that they are respectively estimated to be bad. In the case " of the bankruptcy or insolvency of a debtor, the amount which may " reasonably be expected to be received on any such debt shall be deemed to " be the value thereof ".

The Solicitor-General and Mr. Hills contend that the whole of the selling price must in law for the purpose of Income Tax assessment be brought into the builder's accounts as at the moment of completion, whether the price falls to be recorded by the builder in his accounts as a cash receipt of the whole—a very rare event—or partly as cash and partly as a debt, and whether the debt is secured or unsecured.

It is further contended that the part which is on completion left outstanding as a debt must always in law be brought in at its face value, unless within that same year of assessment it is proved to be " bad " or " doubtful ", so as to entitle the taxpayer under the Rule to have it written off, if bad, or to have it estimated and its total figure reduced to its real value if it is " doubtful ".

They recognise that it is the practice of the Revenue to allow Rule 3 (*i*) to be applied in years subsequent to the year of assessment, but they both concede and insist that such allowances are extra-legal arrangements outside or even contrary to Income Tax law, which limits each annual assessment to its own proper year in regard alike to income to be brought in for purposes of charge and to permitted deductions and allowances.

In effect, their legal proposition is that if a bad or doubtful debt is not proved to be bad or doubtful before the assessment becomes final and conclusive, there is never again any legal opportunity for rectifying the overcharge of tax; and that appears to me to be an injustice, although it may be the present law.

So pure is their doctrine that they treat as *prima facie* good for its face value, every debt, whether, under the terms of the contract which gave it birth, it is or is not to be paid within the year, and even if it is not payable till a date years ahead or is only payable by fixed instalments over a long period of years.

Such a debt may only be *solvendum in futuro,* but, say the Revenue, it is *debitum in praesenti,* and that is enough to bring it into charge as a component of the year's actual profits and gains. Not only do they seek to bring into charge in the assessment year debts only payable in future years, but contend that the normal financial operation of discounting in order to arrive

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at present value is contrary to Income Tax law; and that as the year of assessment is strictly self-contained, the resultant overpayment of tax through the overvaluation of a debt only payable in future years is irremediable, for it can never in law be rectified.

It was argued by Mr. King as an alternative (which I think rests on no basis of fact in this appeal) that the case is governed by *Cronk's* case, the argument being advanced on the footing that the second mortgage in each transaction was a part of the consideration for the purchase and therefore to be valued as a part payment in kind on the principle enunciated in Lord Thankerton's judgment in that case, where the tripartite arrangement between builder, purchaser and building society was held to constitute a part payment of that type([1]).

Mr. King's difficulty is that that contention presupposes an interpretation of the facts stated, which, in my opinion, is erroneous. The reality of each of the Appellant's transactions was that the balance of the consideration, over and above the purchaser's cash deposit and the society's cash advance on first mortgage, was simply not paid over to the Appellant, either in cash or kind. The Appellant gave credit, although he required and got the security of his second mortgage, with the added advantage in some of the sales of a four-year promissory note, with the possibility it afforded of speedy judgment under Order XIV. It follows that the whole balance of the consideration was payable to the Appellant in sterling and not in kind.

We are therefore only concerned with sterling " debts ", and have not to consider the problem dealt with in *Cronk's* case, and in *John Emery & Sons* v. *Commissioners of Inland Revenue,* 20 T.C. 213, of putting a value on the part consideration not expressed in sterling.

The questions we have to decide concern (*a*) the legal effect of the postponement, effected by the contractual arrangements for sale, of the due dates for payment; and (*b*) the application (if any) of the " bad and doubtful " debts " Rule to those sterling " debts ", the badness of or doubts about which do not become manifest till a time when the assessment in which they are treated as having been received by the taxpayer has become final and conclusive, so that it cannot be reopened.

It is difficult in my opinion to exaggerate the practical importance of getting Income Tax law about debts on to lines which are both fair and clear. At present they seem to me to be neither. Whether it can be achieved wholly by judicial elucidation of the law without legislation I very much doubt, although, after such careful consideration as I can give it, I think much can be done by judicial decision upon the law as it stands.

A fundamental matter for consideration is that debts, whether in cash or in kind, which ultimately prove bad or " doubtful ", seldom disclose to the creditor their inherent weaknesses at the time when they are contracted, but only later on. *Ex hypothesi,* under the annual system of assessing, charging and collecting Income Tax, the horizon which limits the scope of all ascertainment of taxable income is the twelve months' period fixed by the beginning and end of the accounting year on which the assessment is based, alike for receipt of income as for deductions and allowances, save in so far as there is statutory provision for action of any kind after that period has expired, whether for additional assessments or for rebates, or for adjustments and rectifications.

For such subsequent revision of bad or doubtful debts, no such statutory provision is made. It is none the less patently fair and just that if tax has

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([1]) 20 T.C. 612, at p. 641.

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been paid on a debt which, when brought into credit for purpose of charge, seemed good but was bad, in the sense of having what I may call "a latent "defect", the Crown should return the overpaid tax when the truth is discovered.

And it is in reality this moral view which is in fact taken by the Revenue authorities and applied in their extra-legal practice. Mr. Hills specifically told us so. It also appears in paragraph 7 of the Case that the Appellant's accountant, who regularly did his tax work, gave this evidence:—"The "figure of sales in the profit and loss account included the nominal amount "of second mortgages and promissory notes. The Respondent had in every "year allowed a deduction for debts (secured by second mortgages or pro-"missory notes) proved to be bad, and the amounts of these deductions are "agreed subject to the question of principle at issue. After the decision in "*John Cronk & Sons, Ltd.* v. *Harrison*, 20 T.C. 612, he wished to reopen "the accounts."

The existence of this non-legal practice and its past application to his own assessments, coupled with the knowledge that he has no legal right to the indulgence, is no doubt the explanation of the Appellant's second contention before the Commissioners (see paragraph 8 (*b*) of the Case) "that, "if a valuation be found to be impracticable, then the sums received under "the second mortgages or the promissory notes are assessable as trading "receipts in the trading years in which they are received."

Indeed, the Commissioners, whilst finding in favour of the Crown that "on the granting of a second mortgage or promissory note . . . a trade "debt . . . was created (*sic*)" and therefore, according to them, had to be included for purpose of charge at its face value, added, "These debts, if "and when proved to be bad, would be allowable as deductions in the "normal manner." The word "normal" shows how common the practice has become, in order to be fair to the taxpayer in spite of the law.

The Appellant's position in the present case is, as I have already said, essentially different from the builder's position in *Cronk's* case; here the building society had no concern in the matter beyond its rights as first mortgagee. It is true that the recital of full payment in the conveyance or land certificate of transfer resembles the recital in *Cronk's* case; but, as was there pointed out, the purpose of that recital is only to protect the purchaser on a resale by him and is not to estop the vendor or the Court from proving or enquiring into the real facts: and there is no other similarity. The Appellant's alternative contention based on *Emery's* case[1], and *Cronk's* case therefore need not be further considered.

The questions of law directly and indirectly raised are of great and general importance alike to the taxpayer and to the Revenue. The curious thing is that they seem to have hitherto, in greater or less degree, escaped judicial determination. Their attendant difficulties arise in the main out of the inflexible rule of Income Tax law that each year's assessment of income for the purpose of charge is self-contained and cannot be altered after the assessment has once, by the lapse of time for appeal or by final judgment on appeal, become "final and conclusive", unless there is some express statutory provision which permits alteration in favour either of the Revenue or the taxpayer—which there is not.

The simplest way of stating the problem is to ask the question: What debts ought to be included in the taxpayer's return of the true balance of his profits and gains as the basis for his assessment? And that question

(1) 20 T.C. 213.

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depends primarily on the meaning to be attributed to the noun " debts " in Rule 3 (*i*). Does that word, as the Crown contends, include not only debts which are " owing ", but also those which are " accruing " and will not be " owing " till after the end of the accounting period which constitutes the basis of the year's assessment?

The contrast of meaning between those two adjectives is forcibly illustrated by Order XLV of the Rules of the Supreme Court, formerly Section 61 of the Common Law Procedure Act, 1854. To prevent misconception in what follows, let me state in advance that I am assuming, for the purpose of the present appeal, the correctness of the proposition that debts which both accrue and become owing and payable within the accounting year are properly included for assessment in the account of the profits earned during that year as if they were cash receipts, even though they in fact remain unpaid at the end of that year by reason of the debtor's default. That question does not arise for decision in the present case; but several difficult questions of Income Tax law have to be thought out. To clarify the position, it will be useful to analyse the Income Tax problem about debts into a series of distinct though related questions.

(1) Do contractual promises to make payment at some future date subsequent to the standard year, whether in one lump sum or spread by instalments over several years, with no right in the payee to demand payment at any earlier date than the due date (except sometimes on default), give rise, in the standard year when the contract is made, to " debts " which the payee, as trader, is under legal obligation to bring into his Income Tax return of his actual profits in the standard year during which the contractual obligation arose?

(2) Even assuming absolute certainty of ultimate payment, must such so-called " debts " be brought in at their face value, although in order to ascertain their present value in the market their nominal amount has to be discounted?

(3) Has Rule 3 (*i*) of the Rules applicable to Cases I and II any and what application to the so-called " debts ", referred to in questions (1) and (2), which are neither bad nor doubtful, but only payable at a future date?

(4) If a debt of the description mentioned in (1) and (2), which is " good " in the sense of not being as yet proved to be either " bad " or " doubtful ", is brought in as equivalent to cash, but in a subsequent year turns out to be bad or doubtful, has the taxpayer who has paid tax on it (calculated *ex hypothesi* on its face value) any legal redress?

(5) If, before the assessment is closed, a risk of ultimate default in payment exists and the debt is proved to be doubtful, and is accordingly valued down in the assessment, but the devaluation proves in a later year to have been insufficient, is there then any redress open to the taxpayer? Or, conversely, if the devaluation proves to have been excessive because the debt after all proves to be good, or not so bad as was supposed, can the Revenue then make an additional assessment?

This question raises the definite issue whether there is or is not statutory sanction for the Inland Revenue practice of making an allowance to the taxpayer in a subsequent year, when a debt, originally taxed on face value, turns out to be worth less than the figure upon which the taxpayer paid, or even to be wholly irrecoverable. Is the practice (*a*) lawful, (*b*) devoid of legal sanction, or (*c*) contrary to law and therefore prohibited?

What is really the same legal problem from the taxpayer's angle, though argued for the Appellant as a separate point, may be posed in terms of the

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convenient accountancy usage of bringing the item " sundry debtors " forward at the beginning of the annual account, and then allowing for bad debts, first discovered to be bad in that year, in the carry-forward of sundry debtors from that year's to the next year's account.

This way of bringing forward a lump sum for sundry debtors, as for stock-in-trade at the beginning of the year, and carrying a comparable figure forward at the end of the year, has led to the use of the phrase " circulating " capital " as a description of such items.

Question (6) might therefore be: Are the above commercial ways of treating debts, which are intended to bring the accountancy results of businesses carried on for profit into harmony with their true commercial results over a succession of years, consistent with Income Tax law? If the answer is No, as it may well be, a very serious defect exists in our tax legislation, and one which calls loudly for statutory amendment.

Bearing all the above aspects of the problem in mind, I start with the present position. The Income Tax Acts contain no provision which in positive terms enacts that in computing the balance of profits or gains, " debts " are to be brought into charge. The nearest approach to it is the negative direction in Rule 3 (*i*) that " no sum shall be deducted in respect of . . . any debts, " except " bad or doubtful debts. That Rule seems to assume that the merchant's annual account exhibiting the profits or gains of his business will, or may, contain not only actual receipts (in cash or value) but also amounts only receivable in future years, not yet in-gathered, because credit has been promised in the contract or gratuitously permitted.

It is impossible to read the Rule without recognising its apparent assumption that some debts may be commercially an element in the annual balance of profits, and may therefore appear as items on the receipt side of the account on which the taxpayer is to be assessed. The statutory position of debts is thus, in my opinion, so ambiguous that it is right to examine the history of the revelant legislation both in its language and by reference to contemporaneous practice in business.

So far as I know, debts have never in any Income Tax Act been expressly brought into charge as an ingredient of profits. The nearest approach is the above implication of chargeability in Rule 3 and its predecessors in earlier Acts. In the 1799 and 1803 Acts there was no reference to debts even in that restricted context.

The germ of the " no deductions " Rule first appeared in Section 84 (the Schedule D Section) of the 1803 Act, but was there limited to the topic of " repairs ". " Debts " were first mentioned in the Rule in Section 112 (the Schedule D Section) of the Act of 1806 (46 Geo. III, c. 65), which repeated the third Rule of the 1803 Act about repairs and added many of the prohibitions against deductions now contained in the third Rule of the 1918 Act. The 1806 form of the Rule about debts was: " nor for any debts, except such " debts, or such parts thereof as shall be proved to the satisfaction of the " Commissioners respectively, to be irrecoverable and desperate ".

The provision for a deduction was there limited to debts wholly or partly bad, doubtful debts not being mentioned. Income Tax was abandoned after Waterloo and not revived till the 1842 Act. The third Rule of 1806 was then re-enacted, most of it in almost identical language, in Section 100 (the Schedule D Section), but the dramatic epithets about " debts " were abbreviated into the plain word " bad "—" nor for any debts, except bad debts " proved to be such to the satisfaction of the Commissioners "; but in my opinion the substitution of the epithet " bad " for " irrecoverable and

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" desperate " made no relevant change of meaning. " Doubtful " debts were first brought in by the 1853 Act, Section 50 of which provides that: " In " ascertaining, estimating, or assessing the profits of any person chargeable " . . . it shall be lawful to estimate the value of all doubtful debts due or " owing to such person "; and then, after making the bankruptcy provision which is repeated in the third Rule of the 1918 Act, adds: " and the duty " chargeable . . . shall be assessed and charged upon the estimated value of " all such doubtful debts accordingly." This addition was not re-enacted in the 1918 Act, Schedule D, Cases I and II, Rule 3—I think probably because it was thought to be redundant.

Before discussing the above history of Rule 3 (*i*), I call attention to the language about doubtful debts used in Section 50 of the 1853 Act. The words " due or owing to such person " were really superfluous. They were evidently inserted only to make it doubly clear that it was debts owing to and not by the taxpayer with which the Section was concerned.

In the next session after the Income Tax Act, 1853, Parliament passed the Common Law Procedure Act, 1854, Sections 60 to 67 of which introduced the process of attachment of debts into our common law system, and made it applicable not only to debts " due or owing " but also to debts " accruing ", though payment of the latter type of attached debt could not be enforced on the garnishee until it was accrued due.

Order XLV of the Rules of the Supreme Court is from this angle a mere repetition of the Common Law Procedure Act. The two words " due " and " owing " in the Income Tax Act, 1853, were in my opinion tautologous, the " or " being only exegetic; the whole phrase meant a debt of which the due date for payment had arrived so that the debt was then " owing ". This is borne out by the definition of the word " debt " in the Oxford Dictionary:— " Debt. 1. That which is owed or due: anything (as money, goods or " service) which one person is under obligation to pay or render to another: " *a*, a sum of money or a material thing. 1596 Shakespeare: Taming of the " Shrew iv. iv. 24: ' Having come to Padua to gather in some debts '. 1845 " Stephen's Laws of England II, p. 144: ' Whenever a man is subject to a " ' legal liability to pay a sum of money to another, he is said to owe him " ' a debt to that amount '."

The addition of the alternative epithet " accruing " to the word " debts " in the Sections of the Common Law Procedure Act, 1854, about attachment of debts, thus affords a significant contrast to the omission of it in Section 50 of 1853. It invites the inference that Parliament in the years 1853–1854 realised quite well that, if debts which were merely " accruing ", but not yet " due or owing ", were to be brought in, it was essential to add the words " or accruing ", because the meaning of the bare word " debts " did not go beyond debts already due for payment and therefore presently recoverable, that is to say such debts as would found a bankruptcy.

In the bankruptcy legislation of the 18th century a " debt " always meant a debt of which payment was already due. But even in the Income Tax Act, 1842, it seems to me difficult to suppose that the Legislature could have intended to legislate for deduction of debts as " bad ", if they were not due for payment till future years; the intention must surely have been to legislate about debts which had proved " irrecoverable ", that is to say because they had fallen due for payment, but had not been paid, and because some further fact was known such as the bankruptcy, insolvency or disappearance of the debtor which made the prospect of enforcing payment hopeless.

That such must have been the intention of Parliament in 1806 seems to me plain from its picturesque language used to describe bad debts—

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"irrecoverable and desperate". And I reject as absurd any contention that the change of those two words into the one word "bad" in 1842 is any indication that the Legislature was then intending that debts, not payable in the year, upon which the assessment was to be based, should be brought in, or that the deduction for bad debts was to apply to any debts except those of the same category.

If, in spite of the statutory history of the language used, it be thought that there still remains any ambiguity in the meaning of the Rule, I think the doubt should be disposed of on another ground. In 1806 the methods of business in the trades and manufactures to which Schedule D, Case I and its Rules, were addressed were very different to what they had become in 1918; and the language of 1806 should be construed in the light of those characteristics of profit-making businesses which were familiar to Parliament in 1806.

If the natural meaning of the unqualified word "debt" in the English language was at that time a debt which has accrued due for payment, that *prima facie* is the proper interpretation of it in any contemporaneous legal context; and that should still *prima facie* be its interpretation, even if popular usage may have enlarged its meaning in the course of time since the statutory or other legal context took shape.

But if the change in popular usage, which has led to the wider denotation, has itself resulted from changes in methods of business in the intervening years, since the date when the legal context in question took shape, that is not merely a *prima facie* reason, but an almost conclusive reason for not giving the old word in the old legal context—particularly in a taxing Act—the new meaning which has gradually become attached to it by popular usage.

It may be that an extrinsic change of this kind, in regard to the scope of the word "debts" in common parlance, has occurred since 1806. At the end of the eighteenth century long credit was common, but rarely, I think, under contractual postponement of due dates for payment. Since then business changes have of course been immense. The whole system of limited liability has grown up since the middle of the nineteenth century.

Many contractual methods were then unheard of which today give rise to long fixed credits, especially for payment by instalments. The search for profitable outlets for enterprise has led to strenuous endeavours to find new markets; and in the home market the vast size of the employed population of the United Kingdom has attracted attention, and stimulated ingenuity in the discovery of means of making large profits out of what may be regarded as mass contracts which persons having definite wants but small incomes with which to satisfy them.

The successful prosecution of such a plan imposes two conditions—the acceptance of payment for an expensive article by degrees out of the purchaser's small current earnings, and the discovery of some kind of security to reduce the risk attaching to such extended credit. "Easy payment" is essential to create the market demand; but with reasonable security against default large profits may result. I think that that is the history for instance of hire-purchase.

The more elaborate, but essentially similar system of speculative building of houses for persons of small means is equally the result of the same economic causes; although it could not have grown up without the building societies, which finance so large a part of each transaction as to make the credit risk for the speculating builder a business proposition sufficiently safe to attract him.

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There were small building societies earlier, but the first of the large modern building societies was apparently registered in 1847—that is, not till five years after the 1842 Income Tax Act. For the modern magnitude of building societies' operations and the dates when the societies started, see Whitaker's Almanack for 1943, pages 558–560. Long term instalment contracts are an essential ingredient of all such businesses—nay more, they are their absolute foundation.

I regard it as an anomaly that any debt, even one payable in the standard year, should be brought within an Income Tax assessment as if it were a cash receipt, and an injustice, unless complete relief can be given in respect of tax paid upon debts so brought in if and when in subsequent years they prove to be wholly or partly irrecoverable; and indeed, in justice, such relief should include interest on the money so overpaid to the Revenue.

None the less, having regard to the statutory history of the practice and of Rule 3 (*i*), I have, as I have already said, assumed (without expressing any opinion) the legality of the practice of charging the taxpayer in respect of debts contracted and due for payment within the year; but I reject the argument for the Crown that all debts, in the wide meaning which they give to the word, are intended by the Acts to be treated as the equivalent of cash, unless proof is forthcoming, before the assessment of "the balance of the "profits or gains" becomes final and conclusive, that they are bad or doubtful; and also the Crown's further argument that they are to be included for purpose of charge at their face value.

The judgment of the Privy Council, delivered by Lord Buckmaster, in *Gleaner Co.* v. *Assessment Committee* (of Jamaica), [1922] 2 A.C. 169, (where Jamaican law was the same as our own), lays it down quite clearly that no deduction for the badness of a debt can be made except in the selfsame assessment as contains the original credit entry of the debt—see page 173; but, on the other hand, their Lordships carefully limit the debts which can be brought into an assessment to those which have accrued due for payment in the year on which the assessment is based.

It is in truth vital in all the questions which I have posed in this judgment never for a moment to forget the legal position that each year of assessment is for all purposes self-contained; and that once the assessment has become final and conclusive, it cannot be reopened or altered, unless there is some express statutory provision for that purpose—whether in favour of the Crown for additional assessment, or in favour of the taxpayer for adjustment of losses, or for rebates.

In *Gleaner's* case, at page 174, the Privy Council said categorically that there is no legal provision in English legislation for any allowance or deduction for bad or doubtful debts except out of the profits to be brought into charge in the year of assessment. On page 175 the Board discusses the very practice which has been followed by the Appellant's accountant and by the Income Tax authorities for years in dealing with the present Appellant's assessments; a practice which has been endorsed by the Commissioners who stated the present Case. "Their Lordships", Lord Buckmaster said, "are "unable to attach any weight to this practice." In truth, it was recognised by both sides before us that any such practice is wholly extra-legal.

I therefore approach the problem of construing Rule 3 about debts with the conviction in my own mind that Parliament did not intend any allowance for debts charged at their face value in one year of assessment to be made if and when they should prove in subsequent years to be bad or doubtful. It would be so grievously unjust for no remedy to be available to the subject

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in such a calamity—for it might well be for him a most serious financial calamity—that, unless the words of the Rule, or of some judicial exposition for the Rule binding on this Court, are too clearly against the view which I take to permit of doubt, I think we should construe the words " any debts " in respect of which " no sum shall be deducted " in a way which will prevent that injustice.

And in that context I pray in aid the rule of interpretation of ambiguous language in favour of the taxpayer. I also bear in mind that the context in connection with which the " debt " is to be scrutinised is the account of profits upon which the assessment is founded.

In *Russell* v. *Town and County Bank,* 13 App. Cas., at page **424**; 2 T.C. 321, at page 327, Lord Herschell said: " The duty is to be charged upon ' a sum " ' not less than the full amount of the balance of the profits or gains of " ' the trade, manufacture, adventure or concern;' and it appears to me that " that language implies that for the purpose of arriving at the balance of " profits all that expenditure which is necessary for the purpose of earning " the receipts must be deducted, otherwise you do not arrive at the balance " of profits, indeed, you do not ascertain, and cannot ascertain, whether " there is such a thing as profit or not. The profit of a trade or business " is the surplus by which the receipts from the trade or business exceed the " expenditure necessary for the purpose of earning those receipts. That seems " to me to be the meaning of the word ' profits ' in relation to any trade or " business. Unless and until you have ascertained that there is such a " balance, nothing exists to which the name ' profits ' can properly be " applied."

In *Gresham Life Assurance Society* v. *Styles,* [1892] A.C. 309, at page 322; **3** T.C. 185, at page 194, Lord Herschell said: " When we speak of the " profits or gains of a trader we mean that which he has made by his " trading." In the present case, how can it possibly be said that the Appellant made in the year **1934-35** profits to an extent measured by the face value of the totality of instalments thereafter payable to him under his second mortgages over a future period of 22 years or so, or even of his promissory notes payable over four years?

The only way of preventing that injustice, which will also be consistent with the implied provision (which I have assumed) that some " debts " are to be brought in, is to construe the word as limited to debts which fall due for payment in the accounting period on which the assessment is based. This would exclude altogether debts not payable at all till after the end of the standard year, and all future instalments falling due for payment after that date.

On the whole, I think that is the right view to take about the inclusion of debts as the general result of Income Tax law as well as of Rule **3** (*i*). Such a reduction of the assessment figures in the present case should, in my opinion, be made for each year in question, as will exclude all instalments not yet due for payment in that year.

That leaves one question still open—the question about bad or doubtful debts. If such badness or doubt can be shown in regard to a debt or a particular instalment of a debt falling due in a relevant year, before the assessment then open is finally closed, an allowance can be demanded in respect of the debt or instalment which fell due within that period. If in that year the debt became " bad ", no instalment would have been paid, and relief will be obtainable under my previous conclusion. If evidence is forthcoming that such a debt is " doubtful ", though not definitely " bad ",

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some allowance can be made for that year, leaving future doubts or defaults to be settled in future years.

The problem of how to value doubtful debts, which are presently payable, remains, though it is not necessarily involved in our decision today. I venture to express the opinion that the only satisfactory solution for what must be a very common hardship, especially in these days of financial difficulties, is a legislative amendment putting the taxation of profits on to the footing of actual receipts so that, in Lord Herschell's words, the man taxed on his business under Case I of Schedule D will in fact only have to pay on " the profits he has made ".

No judicial countenance can or ought to be given in matters of taxation to any system of extra-legal concessions. Amongst other reasons, it exposes Revenue officials to temptation, which is wrong, even in the case of a service like the Inland Revenue, characterised by a wonderfully high sense of honour. The fact that such extra-legal concessions have to be made to avoid unjust hardships is conclusive that there is something wrong with the legislation.

The taxpayer ought to know where he is, and the fact that there are great temptations to avoid the tax-gatherer's net, especially with present rates of taxation, is not, in my opinion, any reason for tolerating the continuance of an unfair provision in the tax legislation of the country. But my brethren differ, and judgment will be as they direct.

I have read and considered their judgments with care. I cannot agree with them, but differ with doubt in what appears to me to be a very difficult case. That some legislation is needed, I feel convinced. How much, depends on what the law now is. I hope that this case may go to the House of Lords, as I think it of high public interest that the difficult question which it raises should be elucidated there.

The appeal should, in my opinion, be allowed and the case remitted to the Special Commissioners to adjust the assessments in accordance with the principles laid down in this judgment.

Luxmoore, L.J.—The problem to be solved is how ought the annual profits of a builder to be assessed for Income Tax where the method of trading consists in the purchase of land and its development as a building estate by the erection thereon of houses which are sold to purchasers of small means on the terms that a part only of the purchase price is paid on completion while practically the whole of the balance is payable by instalments spread over a number of years and secured either by promissory notes or second mortgages.

The Special Commissioners held that the builder was bound to bring into account at face value for the year when the contract for sale was made (*a*) the part of the purchase price paid in cash and (*b*) the part which was made payable by instalments. The builder appealed from the decision of the Special Commissioners and contended that the outstanding part of all purchase money in respect of sales made in a particular year of assessment ought to be valued as at the end of that year, or, alternatively, that if it was not possible to make such a valuation each instalment should be treated as a trading receipt in respect of the year in which it was received and not in respect of that in which the sale was made.

The appeal came before Macnaghten, J., who held that the decision of the Special Commissioners was correct for the reasons given by them. The builder has appealed to this Court.

The material facts are as follows. The Appellant, F. R. Absalom, carried on business at all material times to 31st December, 1937, when he retired.

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The business in which he had been engaged is described as that of a speculative builder, though I doubt if there is any distinction between the business of a builder with or without the adjective.

In the course of his business, Mr. Absalom purchased building land, mainly at Erith and Bexley Heath, developed it for building in the usual manner, and erected on it a large number of small dwelling houses. These houses were intended to be sold and were in fact sold mainly to persons in receipt of weekly wages without sufficient capital to purchase a house outright. In consequence, Mr. Absalom made arrangements under which the purchaser of a house could borrow on first mortgage from a building society a sum equal to between two-thirds and three-fourths of the purchase price.

The money so borrowed was paid to Mr. Absalom in satisfaction *pro tanto* of the purchase price; the difference between the purchase price and the amount raised on first mortgage being satisfied by a small payment in cash and as to the balance either by a second mortgage of the property purchased or by a series of promissory notes.

In each case the balance of the purchase price was payable by instalments extending over periods varying from 4 to 22 years, but subject to a proviso that the whole of any outstanding balance of purchase money was to become payable immediately if default should be made in the payment of any instalment.

The total amounts of the assessments to which this appeal relates are £87,000 for the tax year ending 5th April, 1935, £48,000 for the year ending 5th April, 1936, £24,000 for the year ending 5th April, 1937, and £30,000 for the year ending 5th April, 1938. No final assessment has been made in respect of these years and in the circumstances it remained open to Mr. Absalom to challenge the assessments.

The Special Commissioners found that all the trading accounts of Mr. Absalom from 1933 to 1936 had been prepared on identical lines; the figures for sales of houses in each year included, in addition to the moneys actually received by him in respect of purchase price and deposits, the actual sums secured by second mortgages or promissory notes as the case might be.

These last-mentioned sums were brought into the accounts of the year at their respective face values without any deduction or allowance; but the Inspector of Taxes had in each year allowed a deduction to be made in respect of monies secured by second mortgage or promissory note in respect of sales effected in earlier years when the monies so secured had proved to be irrecoverable during the year when the allowance was made.

The Special Commissioners held that on the granting of a second mortgage or a series of promissory notes by the purchaser of a house, a trade debt due from the purchaser to Mr. Absalom was created, and that in computing his profits and gains it must be included at face value in the account for the year under consideration.

The language of this finding I think gave rise to some misapprehension during the course of the argument of the appeal, for it was treated as referring to the face value of the instalments payable under a second mortgage or a series of promissory notes. The position is perhaps best explained by reference to the documents relating to the purchase of a house by one Mayhew which are annexed to the Stated Case.

The total purchase price was £425. £40 was paid by the purchaser in cash, £320 was raised by first mortgage and paid to the vendor, while the remaining £65 was secured by second mortgage of the house to Mr. Absalom. This last-mentioned sum was made payable by monthly instalments of

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8*s*. 2*d*. extending over a long period of years, each instalment being made up partly of capital and partly of interest at 5½ per cent. per annum. The aggregate of these instalments was naturally far larger than £65, but the sum brought into account for Income Tax purposes was £65.

On the form of the transaction the whole of the purchase price was paid by the purchaser to the builder, who then advanced a part of the purchase price on the security of a second mortgage or a series of promissory notes. From this point of view no question could possibly arise, for the payment of the whole purchase price has been made by the purchaser to the builder: but in substance, having regard to the financial position of the purchaser, the purchase consideration has been treated as composed of two parts, the first being a sum of cash payable on the conveyance of the property to the purchaser and the balance a sum of cash secured by second mortgage or a series of promissory notes repayable at the option of the purchaser either under the second mortgage or the promissory notes or by instalments spread over a number of years, the instalments being so arranged as to provide for the repayment of the balance left unpaid at the date of conveyance with interest at 5½ per cent. per annum by equal monthly payments during the whole of that period.

The option was in fact exercised by the purchaser and consequently the unpaid balance became repayable by instalments which include both capital and interest. The earlier instalments are composed chiefly of interest while the later instalments are composed chiefly of capital. The arrangement also included a term that, if default was made in the payment of any instalment, the vendor could at once insist on the repayment of the capital sum then outstanding with the appropriate interest.

The result of the transaction was that the £65, the unpaid balance of purchase money, remained due to the vendor from the purchaser, but the purchaser had the right to repay it by instalments with interest at the agreed rate. It is true that if the purchaser exercised his option to repay by instalments and performed his obligations the vendor could not require repayment of the debt except in the manner agreed, but in order to ascertain the vendor's profits and gains the transaction had to be brought into the accounts for the year when it took place.

Mr. King, on behalf of the builder, argued that the transaction did not constitute a debt within the meaning of Rule 3 (*i*) of Cases I and II of Schedule D and that he was entitled to treat the second mortgages or series of promissory notes as items of property having money values which after being valued ought to be brought into account at those values.

This argument was said to be based on the decision in *John Cronk & Sons, Ltd.* v. *Harrison,* 20 T.C. 612. In my judgment it must be rejected, for it is plain that in the case cited the subject-matter of the valuation was not of anything provided by the purchaser but of a deposit made out of the purchase price by the vendor in favour of the building society which might, either in whole or in part, be irrecoverable by the vendor.

In my judgment, where the purchaser elects to pay part of his purchase price with interest by equal instalments over a number of years, the vendor is bound, for the purpose of ascertaining his annual profits, to bring in the capital value of the instalments at a sum equal to the capital sum repayable by those instalments.

This has nothing to do with and cannot be described as making a deduction from debts represented by the instalments. It is an ascertainment of the profits by reference to the sale consideration. Those parts of the instalments

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which represent interest are properly excluded from the account and are subject to Income Tax in the respective periods when they are received.

No question is raised by either side in respect of the valuation of the instalments at a sum equal to the outstanding part of the purchase price; but it is argued on behalf of Mr. Absalom that he is entitled to take into account in the valuation of those parts of the instalments which represent capital the fact that there is uncertainty that the instalments will be paid in full owing to the fact that the security is insufficient and the purchaser may be unable to pay if he should from illness or other causes cease to be a wage-earner.

It was further argued that unless he is so entitled he is likely to suffer hardship. The answer to the question whether Mr. King's contentions are correct or not depends solely on construction. What is the true nature of the purchaser's liability to pay the outstanding balance of his purchase price? Is it a debt or does it constitute property falling into some other category?

In ordinary parlance " debt " is the proper description to be applied to money which is owing and remains unpaid, whether the due date of payment has arrived or not, as witness the well worn phrase " *debitum in praesenti,* " *solvendum in futuro* ".

With all respect to my brother Scott, I can find nothing in the Acts or Rules to control the meaning of the word " debts " in Rule 3 (*i*) so as to limit it to debts due and payable. The Rule provides that " In computing " the amount of the profits or gains to be charged, no sum shall be deducted " in respect of . . . (*i*) any debts, except bad debts proved to be such to the " satisfaction of the commissioners and doubtful debts to the extent that " they are respectively estimated to be bad."

In my judgment the capital sums secured by the second mortgages and promissory notes are debts within this description and are none the less so because they are said to be secured by second mortgages or promissory notes.

Mr. King admitted in the course of his argument that he was not in a position to prove in the year when a sale was effected that the purchaser's debt was either bad or doubtful, and consequently he had no answer to the argument put forward on behalf of the Crown if Rule 3 (*i*) of Cases I and II of Schedule D applied.

With all deference to Counsel, I think it might well be open to Mr. Absalom to prove that, having regard to the class of persons who constitute his purchasers and to the actual experience of past years of trading that a percentage of debts outstanding in respect of houses sold in fact turns out to be irrecoverable, the whole of the debts incurred in any year are doubtful and consequently a percentage deduction could be made in respect of them to cover the estimated proportion expected to be found to be irrecoverable. But this aspect of the case cannot arise on this appeal.

I have arrived at the conclusion that the finding of the Special Commissioners and the judgment of Macnaghten, J., were correct, and consequently, in my opinion, this appeal should fail, with the usual consequences.

du Parcq, L.J.—The only question to be determined on this appeal is whether it was proper to apply Rule 3 (*i*) of the Rules applicable to Cases I and II in the computation of the Appellant's profits and gains. If the answer is Yes, then by common consent two results follow. (1) The full amount of the debt must be brought into account in the year when it was incurred, subject to such deductions as the Rule permits; (2) the proof or estimate of bad and doubtful debts under the Rule must, in strictness, be made in, as well as for the purposes of, the year of assessment.

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In order to answer the main question it is necessary to dispose of two subsidiary questions. First, do the words " any debts " in the Rule extend to include debts which are *debita in praesenti, solvenda in futuro*?

In my opinion the answer is that, since Rule 3 deals with the computation of profits and gains, the words " any debts " must be taken to include all obligations which a trader would naturally describe as " debts " and as such would bring into the computation as assets. If this opinion is right, there can be no doubt that debts which, *ex contractu*, are payable in the future, fall within the description " any debts ".

I do not think that the fact that the contract provides for payment of the debt by instalments affects the question. If a debt the payment of which is postponed for a long time is a " debt " within the Rule, it can make no difference that the contract requires the obligation to be performed not by a lump sum payment at the end of a period but by a series of payments spread over a period.

It is to be observed that in the present case the debtor might, if he chose, upon giving the statutory notice, pay off his debt without taking full advantage of the provision in the second mortgage by which, if the debt were paid by instalments, the Appellant (the mortgagee) bound himself to accept such payment. If the debtor elected to do this, however, he would still be liable to pay the full amount of the principal.

No question arises in this case, therefore, as to the proper method of computation in the case of a contract which gives the debtor a choice between paying a smaller sum within a short period, or a large sum by instalments over a longer period. It may no doubt be said that the Appellant would have been prepared to take a smaller sum for each of his houses if the buyer had been prepared to make a cash payment. That is likely enough, but we can only look at the contract in fact made and the amount in fact payable thereunder.

It was suggested in the course of the argument that, though it might be reasonable to insist that a creditor who was entitled to immediate payment should bring the full value of the debt into his computation, it would be unreasonable to apply the same rule to a creditor who was bound by contract to give time for payment. This was put forward as a ground for rejecting the view (which I have adopted) that the Legislature meant to include in the Rule debts payable *in futuro*.

I do not think, however, that the suggested distinction can properly be drawn. The creditor who gives long credit to a debtor from whom payment is immediately due may be said to be according the credit voluntarily, although in the case of an elusive or insolvent debtor the creditor's willingness to wait is not always the most striking feature of the transaction.

In truth, however, the creditor who binds himself by contract to give credit shows at least as much willingness to give it as the creditor who is induced to give it though in law he need not do so. Indeed, since the former enters with his eyes open into a transaction according to the tenor of which he will certainly have to wait for his money, his grant of credit seems to me to be more obviously voluntary than that of a man from whom credit is extracted notwithstanding the terms of a contract which demands prompt payment.

The second subsidiary question is this. In the circumstances of the relevant transactions, is it right to say that a debt remained due from the purchaser of each house, or is the true view that the Appellant received part of the purchase consideration in the form of money's worth? It is, in my opinion, reasonably plain when the substance of the transactions is looked at, that in each case a debt remained due. It was a secured debt but none

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the less a debt. Technically it may be said as to the sum secured by second mortgages that the Appellant had received payment and reinvested the sums paid, but it would avail him nothing if this technical view were taken.

The suggestion that he took the second mortgage not as security for his debt but as a form of payment of the debt equivalent to, for example, a transfer of shares, seems to me to accord less with the reality of the transactions than does the view taken by the Commissioners and by Macnaghten, J., with which I agree.

I now turn to a consideration of the Rule itself. I take it to mean that (subject only to the exceptions specified therein) all debts must be brought in on the credit side of the computation of profits and gains without deduction.

It is, I think, pertinent to inquire what are the deductions which the Legislature had in mind as being deductions which, apart from the prohibition contained in the Rule, the subject might be minded to make. Now, it is plain that a debt payable *in futuro* has less value than a debt already paid or presently payable because of the risk that it may never be paid at all.

One other reason, and I think the only other reason, for saying that a debt payable *in futuro* may have less value than a debt presently payable is that the creditor has not the use and enjoyment of the money until he is paid. I say " may have less value " advisedly; because it may be that, if the debt is secured and satisfactory provision has been made for the payment of interest while it remains unpaid, the creditor will consider that he has made a good investment and prefer that early repayment should not be made.

One can well understand, however, that, but for the provisions of the Rule, a creditor who has given long credit, whether *ex contractu* or as a matter of commercial policy, or because of a combination of forbearance on his part and dilatoriness on that of his debtor, might have made a plausible and perhaps a convincing case for deduction from the total of the debt, which he is bound to bring into account in the year when it is incurred, a sum representing the loss which he suffers through waiting for his money. He might not unreasonably make such a claim even though he was willing to admit that the debt would in all probability be paid in the end.

The effect, and, as it seems to me, the intention of the Rule is to prohibit any such deduction, and I can see no sufficient answer to the contention of the Crown. It was said, no doubt truly, that when the Rule first came into existence the type of transactions with which we are here dealing was unknown. Credit, and long credit, was, however, commonly given in some trades a hundred years ago, and the literature and social history of the period teach us that many persons were willing to take advantage of it, sometimes to their ultimate undoing.

It may well be that a strict application of the Rule to conditions not originally envisaged by the Legislature will result in hardship, but it is not the duty of the Courts, when times and conditions change, to put a new interpretation on statutory provisions so as to mitigate their possible harshness. If changed conditions demand a change in the law, Parliament alone can change it.

Much was made in the argument for the Appellant of the difficulties standing in his way if he sought the allowance of a deduction on the strict terms of Rule 3 (*i*). It is indeed obvious that in the year when a debt is incurred it must be difficult to prove that it is bad or doubtful, and, when it is shown to be doubtful, to estimate the extent to which it is bad.

The difficulties must often be insuperable if it is necessary to base such proof or estimate on an examination of each particular debt and of the

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circumstances of each individual debtor. Whether it would be legitimate in dealing with such a business as that of the Appellant to rely on proof that, according to commercial experience, a certain proportion of bad debts is normal in this branch of commercial activity and to apply the law of averages in making the estimate which the Rule permits, is a question which I will not now seek to answer.

It is enough to say that if, as I think, the Appellant cannot be allowed any deduction except that permitted by the Rule, he has already received the allowance to which he is entitled, although he has agreed to take it in a form which has no statutory sanction. I would add that, if the provisions of the Statute are strictly observed, it must almost always be difficult to estimate the degree of badness of each particular debt even where comparatively short credit is given. To do so requires a prophetic vision which the creditor cannot be supposed to possess: if he were gifted with it, he would have no bad debts.

We were told that, in dealing with some contracts for payment by instalments, the Board of Inland Revenue has devised a method of computation which to some extent may temper the wind to the shorn taxpayer. It might be well if this method were given statutory sanction, but in my opinion the fact of its adoption without such sanction cannot affect our decision in this case.

I would only add, to prevent a possible misunderstanding, that, although the full amount of each debt must in my opinion be brought into the account in the year when the house is sold, the same cannot be said of the interest, which can only be taxed in the year in which it is paid. Payment of interest on a debt is not payment of a debt, and the interest to be received cannot be included in the sum of the purchase price.

I have not referred to the authorities which were cited to us, but I have had them in mind, and, though I think that none of them deals precisely with the points of real difficulty in the present case, I believe that I have said nothing which is inconsistent with them. I have done my best to follow the guidance which they afford.

For the reasons which I have stated, I would dismiss this appeal.

Mr. Hills.—The appeal will be dismissed, with costs, my Lord?

Scott, L.J.—Yes.

Mr. King.—My Lord, may my client go to the House of Lords, if he so desires?

Scott, L.J.—You must ask my brothers.

Luxmoore, L.J.—Certainly, Mr. King. We think this is a case for the House of Lords.

Mr. King.—If your Lordships please.

An appeal having been entered against the decision in the Court of Appeal, the case came before the House of Lords (Viscount Simon, L.C., and Lords Atkin, Thankerton, Russell of Killowen, and Porter) on 14th, 15th, 16th, 17th, 21st, 23rd, 24th and 28th February, 1944, when judgment was reserved. On 19th May, 1944, judgment was given against the Crown (Viscount Simon, L.C., and Lord Porter dissenting), with costs, reversing the decision of the Court below.

Mr. Cyril L. King, K.C., and Mr. J. H. Bowe appeared as Counsel for the Appellant, and the Solicitor-General (Sir David Maxwell Fyfe, K.C.) and Mr. Reginald P. Hills for the Crown.

JUDGMENT

Viscount Simon, L.C.—My Lords, the question in this case is as to the proper method by which to compute under Schedule D, Paragraph 1 (*a*), of the Income Tax Act, 1918, the annual profits or gains arising or accruing to a speculative builder. The nature of the business to be considered is adequately illustrated by two instances annexed to the Case Stated. It is sufficient to take as example the sale by Mr. Absalom in March, 1933, of the fee simple of a house to one James Mayhew on a building estate in Kent which the Appellant was developing. The price of £425 was provided by a cash deposit of £40 made by the purchaser; by £320 paid by a building society which took a first mortgage from the purchaser; while the balance of £65 was provided by a loan from the Appellant to the purchaser and was secured by a second mortgage under which the borrower bound himself to pay to the Appellant the sum of £65 with interest at the rate of £5 10*s*. per cent. per annum by equal monthly payments of 8*s*. 2*d*., with the further provision that the mortgagee will accept payment of the principal sum and interest thereon by the said instalments as long as the instalments are punctually paid.

It is not disputed that the Appellant is carrying on a trade of which the transaction just described is an example. The question at issue is whether the profits and gains arising or accruing from such trade have been correctly calculated so far as the £65 covered by the second mortgage is concerned. The Crown contends that the amounts owing to the Appellant, secured by second mortgages or promissory notes, are debts of his trade, the amount of which must be brought into account, except in so far as a deduction is permissible in respect of bad or doubtful debts under the provisions of Rule 3 (*i*) of the Rules applicable to Cases I and II of Schedule D. The Appellant keeps his accounts on the basis of the calendar year, and consequently his assessment of Income Tax for the fiscal year ending 5th April, 1935, is based upon the figures of his trade for the calendar year 1933. The argument for the Crown is that since he sold this house in March, 1933, he must bring into his account for Income Tax purposes for the year 1934–35 the whole purchase price of £425, notwithstanding that £65 of it was not due and payable in 1933 and would only be paid off gradually, so that if the terms of the second mortgage were duly observed some 22 years would elapse before it was finally discharged.

The Appellant, on the other hand, contends that the sums receivable under the second mortgage fall to be valued at the time of the sale of the houses at their actual value at that time, and not at their face value. A second contention urged on behalf of the Appellant went further, and urged that such part of the price as was not paid or payable within the year 1933 ought not to be included on the profit side of the account for that year at all, but would fall to be included in the later year or years in which they were paid or became payable. It was, of course, a corollary of this last proposition that there should be included in the calculation of profits and gains for the year 1933, instalments paid or due to be paid in the course of that year in connection with the sales of houses previous to that year.

The Case Stated includes the information that the Appellant retired from his business of a speculative builder on 31st December, 1937. It is easy, therefore, to see the importance to him of securing a decision that what

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remained to be paid to him after that date does not properly come within the calculation of Income Tax on his business profits. But there remains to be decided the question as to what is the right mode of estimating the annual profits of his trade.

I have come to the conclusion that neither of the contentions put forward on behalf of the Appellant ought to succeed. When a trader in the course of his trade makes a sale to a purchaser, whether the subject-matter of the sale be a house or any other asset in which he deals, his accounts for the year in which the transaction takes place should, for Income Tax purposes, normally include on the one side the cost of providing the asset with which he has parted to the purchaser and, on the other side, the price for the asset which the purchaser has paid or bound himself to pay. The figure to be entered on the credit side is ordinarily the full price and its face value. If at the end of the year the taxpayer can satisfy the Commissioners that such portion of the debt as has not actually been paid is a bad or doubtful debt, an adjustment under Rule 3 (*i*) of the Rules applicable to Cases I and II may be obtained, though presumably this sort of adjustment is more likely to arise at a later stage. But from the point of view of the trader the relevant time is the time when he parts with his asset to the purchaser, and if the accounts are to set out correctly his profits and gains, the whole consideration must be brought in at that stage, nothwithstanding that a portion of it will not be payable until later, while carrying interest in the meantime. If the transaction took the unusual form of a sale in return for a payment, in whole or in part, of a lump sum in the future, with no interest in the meantime, I should be quite prepared to agree that the debt representing the true price required to be arrived at by taking the present value of the lump sum which is payable in *futuro*. But when the unpaid lump sum (as is usually the case) carries a commercial rate of interest until payment, it is the lump sum itself which enters into the calculation of the price. The decision of this House in the case of *John Cronk & Sons, Ltd.* v. *Harrison,* [1937] A.C. 185; 20 T.C. 612, is distinguishable: in that case there was no question of debt due from the purchaser of the house, and the issue lay beween the builder and the building society.

This is, I believe, the recognised practice of accountants in dealing with returns for Income Tax, and is the method for which the Crown contends. It corresponds to the business sense of the transaction. The Appellant here, in the course of selling the house, becomes entitled to £65 which will be due to be paid him in the future. In the meantime, he is charging his debtor interest and holds security. The position is, therefore, indistinguishable in a business sense from what it would be if the purchaser had paid him the £65 down and he had then lent the £65 back again to the purchaser on second mortgage at a suitable rate of interest. So analysed the transaction is obviously one in which the £65 should be treated as coming into the profit side of his account at the time of the sale of the house, while the interest paid on it will, of course, be liable to tax on each occasion that it is received.

As this appeal has been very fully and ably argued on both sides, I do not wish to leave it without making an observation on Rule 3, paragraph (*i*), which provides that, in computing the amount of the profits and gains to be charged, no sum shall be deducted in respect of " any debts, except bad " debts proved to be such to the satisfaction of the commissioners and doubt- " ful debts to the extent that they are respectively estimated to be bad." It is clear from the words used in the beginning of the Rule that it is concerned with prohibiting various claims for deduction from profits, and has nothing to do directly with declaring what are profits. Yet I cannot help suspecting that it must be sometimes rather hastily read as though it amounted to an

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assertion that trade debts are profits. The true view is that in cases like the present, profits (or losses) so far as due to the particular transaction, arise from the sale and at the time of the sale; the debt representing the price is created by the sale and at the time of the sale. Indeed, the second reason of the Respondent's case is that debts due to the Appellant from the purchasers of houses " were debts within the meaning of Rule 3 (*i*) ". If that were so, the only result would be that such debts necessarily enter into the calculation of profits. To my way of thinking, the reason why debts such as the £65 in this case are to be brought in on the credit side of the account, is because they are an element in arriving at the Appellant's profits and gains, and not because of anything stated in Rule 3 (*i*) at all.

There is a further reflection on Rule 3 (*i*) which it seems appropriate to put on record at the end of the present appeal. At one time in the course of the argument it was suggested that the right to make a deduction for bad or doubtful debts in years subsequent to the year of the transaction creating the debt was conceded only by the benevolent practice of the Revenue. But it seems to me that the Revenue's practice in this respect is not due to benevolence but to statutory law. If in the year when a house has been sold the whole price of the house has been included in the calculation of the vendor's trade profits, and if in a later year it is ascertained that part of the price which still remains to be paid is of doubtful value or is a bad debt, the allowance made by the Revenue is authorised and required by Statute, notwithstanding that the year of sale has passed by. It will be adjusted by an allowance in the later year in which its unsoundness is proved. The judgment of the Judicial Committee, delivered by Lord Buckmaster, in *Gleaner Co., Ltd.* v. *Assessment Committee,* [1922] 2 A.C. 169, may appear to be inconsistent with this view, but the Privy Council was there pronouncing on the Income Tax law of Jamaica, which is not in quite the same terms as our own, and in so far as this is not an adequate distinction, I must say that I find myself, with all respect to the learned former Lord Chancellor who prepared the judgment, unable to accept the proposition there laid down and think that the case should not be followed.

I would dismiss the appeal.

Lord Atkin (read by Lord Thankerton).—My Lords, the problem raised by this case can be stated simply, but its solution evidently affords ground for difference. The Appellant in the years of assessment was engaged in the business of building industrial dwellings which he sold to members of the working class. The business procedure was that the purchaser agreed to buy a house at a price, arrangements having already been made that a building society would advance to him a proportion of the price on a mortgage repayable by instalments over a period of years. The purchaser would provide a small sum in cash, and this cash payment together with the amount provided by the building society would be handed to the builder on completion. The balance the purchaser agreed to pay to the builder by instalments, including principal and interest, over a period which might extend to over 20 years. Thus in one sample case exhibited to the Case Stated, J. Mayhew, described as a labourer (R.A.S.C.), bought a house for £425. He paid £40 down, and the building society advanced to him £320 on mortgage which was paid over to the Appellant. For the balance, £65, the builder took a second mortgage payable with interest at 5½ per cent. by monthly instalments of 8*s*. 2*d*., which would discharge the sum agreed to be paid in rather more than 22 years. The agreement appears to provide that the bargain to receive payment in instalments only lasts as long as the instalments are duly paid. Part of the

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balance was sometimes paid by the purchaser signing a promissory note for such amount payable by monthly instalments over a period of four or five years, but this variation does not seem to affect the main issue.

The issue is whether these marginal sums agreed to be paid to the builder over a period of years ought to be assessed on him for Income Tax in the year of the contract as profits of his trade for that year at the full face value of the sum agreed to be paid, or whether some other and, if so, what assessment should be made. The Commissioners, Macnaghten, J., and the majority of the Court of Appeal have decided that the builder is subject to assessment on the full sum agreed to be paid. With all respect to them, this appears to me to be giving an extremely unnatural and indeed unjust meaning to profits of the year, and I think that the decision cannot stand. I have the less reluctance in differing from the decisions appealed against because they are all based upon a view of an Income Tax Rule, Rule 3 (*i*) of the Rules applicable to Cases I and II of Schedule D, which I believe all your Lordships are agreed will not bear the construction put upon it.

The Rule is: " 3. In computing the amount of the profits or gains to be " charged, no sum shall be deducted in respect of—(*i*) any debts, except bad " debts proved to be such to the satisfaction of the commissioners and " doubtful debts to the extent that they are respectively estimated to be bad. " In the case of the bankruptcy or insolvency of a debtor, the amount which " may reasonably be expected to be received on any such debt shall be " deemed to be the value thereof ".

It was contended by the Crown that the effect of this Rule was that all debts, at any rate all " trade debts ", must be brought into account at their face value subject to such deductions as were permissible under the Rule for bad and doubtful debts, and this construction has been adopted by all the tribunals before whom this appeal came. It appears to have been overlooked that the Rule does not purport to state what debts are to be brought into account, but deals only with deductions which may be made from debts that were brought into account. What debts are to be brought into account and at what value the Rule does not say.

Now no one doubts that in ordinary commercial practice where goods are sold on terms of ordinary commercial credit, three or six months or even more, traders are in the habit of treating the debt so created as part of the profits of the year in which the debt is incurred. Thus, where the business accounts are made up at the end of the calendar year, a sale in December on credit terms which expire in March or April will be regarded as a profit made in December. And this commercial practice is treated by taxpayers and tax collectors alike as involving a just and accurate computation of profits. The obligations so incurred in ordinary trading are treated as firm obligations and as good as cash in hand, and no one is any the worse. If expectations are disappointed, an allowance for a bad debt can be claimed and will be granted. But when one leaves the realm of ordinary commercial credits and has to deal with credits extending over many years, the whole situation is changed.

According to the Crown's contention, it makes no difference whether the price of goods is to be paid forthwith or at the end of 20 years, or by instalments over 20 years, and whether with interest or not, nor apparently is the possibility or probability of the debtor being unable to continue the payments over the whole period a matter to be taken into account. To my mind to treat money to be paid 20 years hence as producing a profit this year equal to money in fact paid this year is to produce a completely unreal conception

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of yearly profit, and I venture to think quite foreign to any commercial ideas on the subject. It will be observed that the suggested rule does not even contemplate the allowance of discount. To style the obligation a trade debt, which it is, does not meet the difficulty. Nor, with great respect, is it conclusive to say that the creation of the debt is the consideration for the delivery of the goods. It is, but the question is still whether the consideration produces a profit in the year in which the purchase is made; and there are some conditions in which that proposition cannot be true, as, for instance, a promise in return for goods to render services over a period of years, or to give in exchange other commodities in a future year or years.

It seems to me, therefore, in the present case, unreasonable to treat the whole sum payable over 20 years as amounting to a profit of the whole face value made in the year of sale. I am, of course, dealing only with the balance of the price: the part of the instalments that are allocated to interest do not come into the calculation. I agree that a sum payable by instalments at interest and fully secured either on mortgage of property or by the obligation of a debtor whose credit is beyond question, as a bank or large insurance company, might well be taken at its face value, for that would be the value of the obligation created. On the other hand, a sum payable without interest, either in a lump sum several years ahead or by instalments, could never be equivalent to its face value in the year of origin. Similarly an obligation created, as in the present case, by members of the working classes, whose ability to pay depends upon continuity of employment and continuance of health and life, and is further burdened by an obligation to pay much larger sums in reduction of the mortgage to the building society, would very improbably be equivalent to the face value. This is plainly indicated by the figures in the accounts exhibited to the Case, which appear to indicate in general terms an annual deficiency of bad debts in respect of these marginal payments of over 20 per cent.

But it is said these are not real difficulties. The taxpayer has for years prepared his accounts on the footing of entering the whole of the marginal payments at their face value, and the uncertainty of the payments is satisfactorily met by the allowances made in subsequent years for bad debts. There seems to have been some doubt on both sides as to whether these allowances in subsequent years are in accordance with law, doubts which are reflected in the judgments in the Court of Appeal. The doubts are due to a decision in the Privy Council in *Gleaner Co., Ltd.* v. *Assessment Committee,* [1922] 2 A.C. 169. I will discuss this case later, but I wish now to state that I entertain no doubt that allowances for bad debts made in subsequent years are legal, and that what has been described as the normal practice of the Inland Revenue in such cases is correct.

But the practice of the taxpayer, acquiescing in the claim of the Inland Revenue, is of little value, when the practice is sought to be put upon a legal footing. As long as a business is continued, and Income Tax rates are fairly constant, it matters little to the taxpayer how his profit is computed; the allowances in future years will remedy the excessive assessment in the first year. But when rates begin to rise, or particularly as in the present case where the taxpayer is retiring from business, the position becomes at once unsatisfactory. It appears to be conceded that once the creditor has gone out of business no further allowances can be made, and thus the excessive assessment of the first year can no longer be compensated. I can see no reason why such an arbitrary method of computing profit, leading to real hardship, should be adopted, when there is no statutory enactment prescribing it. I am

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satisfied, therefore, that the assessment which has been confirmed by the Courts cannot stand.

There are more methods than one of calculating the profit in such cases as the present, and it may be that more than one may have to be adopted. For my part I think that the most satisfactory course would be to put the debts at their face value on the one side and to open a suspense account on the other side, which no doubt would be calculated upon the ordinary risk of bad debts, and adjust it year by year in accordance with the actual payments made. It is said that this is forbidden by Rule 3 (*i*). On the other hand, if that Rule only applies, as I think it does, to debts that are correctly entered at their face value, its provisions would have no bearing on debts which could only be entered at their face value if some such corrective as a suspense account is necessary. Another method which is correct enough in theory is to value the debt. It would thus be treated as an asset received in part discharge of the price, and its value would be calculated according to the experience of the business. I see no reason why the valuation should not be made of each debt, as would appear to be the effect of Rule 3 (*i*)—" to the " extent that they are *respectively* estimated to be bad." Valuation is certainly a rough method of adjusting profit, for there seems no means of subsequent correction by actual results, but at any rate it removes the anomalies that arise otherwise on a discontinuance of business.

Another and more accurate method, as long as the business continues, is that which I understand is preferred by my noble and learned friend Lord Russell of Killowen, which is to enter only in each year the instalments actually paid or at any rate payable. The difficulty, as it appears to me, is that when the creditor retires from business, according to present accepted practice, Income Tax would no longer be chargeable on instalments received after that date. I venture myself to doubt whether this practice is correct; the proceeds would be annual gains, and they would be due to carrying on a trade though not in the year of assessment; it is difficult to see how they would differ from instalments received in the second or third year while business is still being carried on. I can express no final opinion about this, for it has not been argued, but I should like to consider it an open point.

However, there is, I think, no doubt about the practice, and I think therefore that, as the case must go back to the Commissioners, it will be sufficient to leave it to them to settle the right method of adjusting the assessment, feeling that the method of valuation affords least scope for legal doubt, and that in default of satisfactory valuation being possible, they may have to fall back upon the method of taxing instalments in each year as they fall due.

As I have said, I have arrived at this result while accepting the view put before us by the Crown—as I understand in the present case for the first time in this House—that it is in accordance with the Income Tax Acts to make allowances for bad debts in years subsequent to that in which the original debt was incurred. The authority to the contrary is the judgment in *Gleaner Co., Ltd.* v. *Assessment Committee,* [1922] 2 A.C. 169. That case is a decision on the Income Tax Act of Jamaica, but the wording so closely resembles the English Act, from which no doubt it was borrowed, that it is to my mind impossible to distinguish it. The decision clearly lays down that allowances granted under the words of Rule 3 (*i*) can only be made in the original assessment. Nothwithstanding the unfeigned respect I have for the learned Lord who delivered the opinion of the Privy Council, I cannot but remember that occasionally *" dormitat Homerus "*. I see no reason for such

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a restriction, which appears to defeat almost any beneficial effect of the power to render such an allowance. It is often, I should have thought usually, the case that the need for allowance becomes obvious not in the year the debt was incurred, for if doubt arose then presumably the debt would not be created, but at a later period. I am satisfied that the practice of the Inland Revenue coincides with commercial needs, and I am driven to say that in my opinion the case of *Gleaner*(1) was wrongly decided and should not be treated as an authority in English Income Tax law.

For these reasons I am of opinion that this appeal should be allowed, and the case should be remitted to the Special Commissioners for the assessments to be varied in accordance with the opinion expressed in this House. The Appellant should have his costs of his appeal before the Special Commissioners(2), in the Courts below, and in this House.

Lord Thankerton.—My Lords, I agree with the opinion of my noble and learned friend Lord Atkin, except that, like my noble and learned friend Lord Russell of Killowen, I find it unnecessary to come to any final conclusion as to the statutory validity of the Crown practice to make allowances for bad debts in years subsequent to that in which the original debt was incurred. There is no question of any such allowance in the present case, and, without further consideration, I am not prepared to hold that the opinion expressed in the Privy Council in *Gleaner Co., Ltd.* v. *Assessment Committee*, [1922] 2 A.C. 169, is not applicable to the English Acts, or is wrong. With reference to the two cases referred to by my noble and learned friend Lord Porter, I would only note that in ***Anderton and Halstead, Ltd.*** v. ***Birrell***, [1932] 1 K.B. 271; 16 T.C. 200, the allowances were made by agreement, and no such question was raised, much less decided; while in *Reid's Brewery Co., Ltd.* v. *Male*, [1891] 2 Q.B. 1; 3 T.C. 279, it was only by holding that the brewers carried on banking and moneylending as a branch of their business that the Court found the deductions permissible.

I agree with the motion proposed by my noble and learned friend Lord Atkin.

Lord Russell of Killowen (read by Lord Thankerton).—My Lords, this is a very special case. It is the case of the business or trade carried on by a person, who is commonly called a speculative builder, that is, one who buys land and enters into agreements to build houses on parcels thereof, for persons who are not prepared, in return for a conveyance to them of the house and land, to find more than a small proportion of the purchase money. I need not state the methods adopted by the Appellant or the part played in the transactions by the building society. That has already been done, and the details appear in the two cases selected before us as typical, namely, Mayhew and Hearnden. It is sufficient for my purpose to state that in no case did his bargain with the purchaser entitle the Appellant to receive the full purchase money in the year in which he sold and conveyed to the purchaser the house and land; indeed the bargain bound him to wait for many years before the final instalment became due. The instalments payable by the purchaser consisted partly of principal and partly of interest, but if the purchaser made default in payment of any instalment, the whole amount of the purchase money still unpaid became immediately due.

The Crown contends that in computing the full amount of the profits or gains of the Appellant's trade of the year preceding the year of assessment, the balance due from purchasers of houses and land conveyed to them in that

(1) [1922] 2 A.C. 169. (2) *See* page 200 for terms of the Order.

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year in respect of unpaid purchase money, should be included as debts at their face value, notwithstanding the long credit given which entitled the purchasers to pay by instalments extending over many years. In the Respondent's case before this House, this inclusion is stated (curiously enough) to be in accordance with Rule 3 (*i*) of the Rules applicable to Cases I and II of Schedule D, a Rule which relates only to deductions in respect of debts, not to their inclusion. That Rule *per se* does not justify the Crown's contention, nor does any inference which could legitimately be drawn from the Rule. The matter is, however, in my opinion, decided adversely to the Crown by the decision of this House in the case of *John Cronk & Sons, Ltd.* v. *Harrison,* [1937] A.C. 185; 20 T.C. 612. It is true that the facts in that case differed from the facts in this case. In *Cronk's* case the portion of the purchase money withheld from the vendor was withheld by the building society, and might not (in whole or in part) ultimately reach the vendor if the purchaser came in default to the building society. In the present case part of the purchase money is withheld from the vendor by the purchaser, and may not (in whole or in part) ultimately reach the vendor if the purchaser comes in default to him. But in each case the question is the same, namely, whether the amount withheld should be brought into the account on the receipt side at its face value. The Court of Appeal held that the amounts were to be brought in as trading receipts at the time of each sale, not at their face value, but on a proper valuation. We affirmed that decision, but added (in view, I think, of a difficulty which had been anticipated by the Commissioners in making a valuation) that in the event of the Commissioners finding a valuation impracticable, they should not be treated as receipts of trade except in so far as such sums or any part thereof were released to the company (that is, received by the vendors) during the trading periods in question. That authority seems to me inconsistent with the contention that the amount of outstanding purchase money should be brought in at its face value.

For myself, I think that "the annual profits or gains arising or accruing" to the Appellant from his trade in any one year would be most truly computed by including on the credit side of the account his actual cash receipts during that year, and so much of the outstanding purchase moneys as fell due to be paid in that year, that is, treating the latter on the footing of receipts in that year. If and so far as they could properly be deemed bad or doubtful, deductions would be made under the before-mentioned Rule 3 (*i*). If by reason of default the whole of the outstanding purchase moneys had become due, the whole amount would be entered as falling due in that year with the appropriate deduction under the Rule. This method is in effect the alternative suggested by this House in *Cronk's* case in the event of valuation being found to be impracticable.

The majority of your Lordships, however, are of opinion that the proper course to adopt is to value the debts which represent the outstanding portions of purchase money which will be received in subsequent years when and if the successive instalments (which are composed in part of unpaid purchase money and in part of interest) are duly paid. I am not disposed to disagree. It must, however, be borne in mind that this valuation is in no sense a discounting for the purpose of arriving at a present value of a future payment, for the debt is carrying interest until payment. Nor is it a deduction in respect of a bad or doubtful debt under Rule 3 (*i*), for (there being no existing default) there would be no ground for alleging that the debt was either bad or doubtful. Had any default already occurred the whole of the outstanding purchase

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moneys would have become due, and would be entered as a debt immediately payable, with the appropriate deduction under the Rule. No need for valuation in that case would arise. The valuation which I contemplate is one which takes into account all the risks which a creditor runs who (like the Appellant in this case) gives very long credit on doubtful security, and which may at some future time convert a presently good debt into a bad one. In assisting the Commissioners to arrive at such valuation, I can see no objection to evidence being given to show that in the experience of the Appellant in his trade, and of others who carry on the same kind of trade, a certain percentage of these future instalments proves to be irrecoverable.

I would accordingly allow the appeal and send the case back to the Commissioners for them to make a valuation and to alter the assessments accordingly.

I have not found it necessary to express any views upon the true construction of Rule 3 (*i*), or upon the legality of the practice which was described by Scott, L.J., in his judgment as extra-legal(1). As at present advised, I do not think that the Rule permits a deduction in computing the profits of a subsequent year of a debt treated as good in computing the profits of a previous year, and that the practice referred to is a concession to the taxpayer, not a right on his part. But I prefer to keep these points open until the necessity for their decision arises.

Lord Porter.—My Lords, the facts in this case have been fully stated and I need not repeat them.

No doubt the habit of building and selling houses to purchasers who obtain part of the purchase price from building societies whilst for the remainder they continue to be debtors direct to the building owner with or without security, is of recent origin. Nevertheless it is now widespread, and its effect in a form not identical with but similar to that adopted in the present case has already been the subject of a Revenue appeal in your Lordships' House. That in the normal course of affairs it will become even more common is, I think, likely. Your Lordships' decision is, therefore, of importance not only in law but also in fact to a considerable number of taxpayers who will be affected by it. I make these observations because it has been suggested that this is an exceptional case and will have little, if any, effect upon the liability to tax of building owners or other business men.

Debts so incurred and credits so obtained are no doubt an extension of the type of debit and credit customary when Income Tax was originally imposed, but the same language continued to be employed when and after that tax was reimposed, though the content of the word " debt " was being extended to meet changing conditions.

In spite, therefore, of the forcible judgment of Scott, L.J., based upon a historical survey of the conditions originally obtaining, I cannot but believe that the sums owing to the owner by the purchaser are debts as generally understood amongst business men and by accountants at the present time, and come within the express words of Rule 3 (*i*) of the Rules applicable to Cases I and II of Schedule D as set out in the Income Tax Acts.

In the Court of Appeal it appears to have been assumed that, in calculating the profits of a business, debts whether presently payable or not must be brought into account on the credit side at their face value because they are debts, unless indeed they can be shown to be bad or doubtful. Rule 3 (*i*) seems to have been considered to imply that they must be so treated, because

(1) *See* page 172 *ante*.

(Lord Porter.)

a provision as to what deductions are allowable in the case of a debt necessarily implies that it is to be taken into account at its face value save in so far as those deductions are allowable.

My Lords, I do not think that this contention can be accepted in that form. Debts, no doubt, if payable within the year of charge and possibly those not so payable provided they are payable within a reasonable time thereafter, must be taken into account, and when they are taken into account Rule **3** (*i*) prescribes what deductions are allowable. But it does not follow that all debts must be taken into account either in the year in which they are contracted or at their face value.

What has to be ascertained are the profits and gains of the business or, as the wording originally stood, the balance of profits and gains—a difference in language which does not affect the meaning of the provision. In order to ascertain that balance, one has to determine what sums are to be credited and what debited in the annual accounts. No directions are given in the Income Tax Acts as to how those profits are to be ascertained, and in default of direction they must, I think, be arrived at on ordinary commercial principles, subject to such provisions of the Income Tax Acts as require a departure from such ordinary principles, see per the Lord President (Clyde) in *Dailuaine-Talisker Distilleries, Ltd.* v. *Commissioners of Inland Revenue,* 1930 S.C. 878, at page 884; 15 T.C. 613, at page 620; and *Usher's Wiltshire Brewery, Ltd.* v. *Bruce,* [1915] A.C. 433; 6 T.C. 399. As Mr. Konstam says in the latest (1943) edition of his book on the Income Tax Acts, at page **100**: " Speaking generally, the profits of a trade are usually computed for purposes " of Schedule D on an ' earnings ' basis . . . amounts receivable under con- " tracts entered into in the year are credited, and allowance is made for " bad debts ".

So considered it must, I think, be conceded that at the present time debts, whether payable at once or in the future, would normally be treated as an asset of the business in the year in which they were contracted. Rule **3** (*i*) appears so to assume, but they are treated as credits not primarily by reason of the Rule but because business practice follows that course.

Indeed this seems to be the natural course to follow in circumstances such as those under consideration, since upon the sale and transfer of each house the owner has parted with an asset and received in exchange a payment from the building society, together with a debt due from the purchaser secured by a second mortgage, with or without a promissory note in addition.

I find it difficult to think that these items are not to be brought into account as soon as the transaction is completed, or to accept the view that they must wait until each instalment is paid before they are credited. They are present assets though payable at intervals in the future. Indeed, Mr. King did not, save in the last resort, argue to the contrary. His first and main submission on behalf of the Appellant was that they should be taken into account in the year in which the several houses were sold, but at a valuation; and in support of this argument he relied upon your Lordships' decision in *John Cronk & Sons, Ltd.* v. *Harrison,* [1937] A.C. 185; 20 T.C. 612.

If then the debts are to be brought into account in the year in which the various houses are parted with, it has to be determined what value is to be put upon them, and whether they are to be assumed to have their face value or are to be valued otherwise and, if so, upon what basis.

That in some cases they may not have their face value must, I think, be conceded. Indeed I understand that the representatives of the Crown eventually did not dissent from this view. A simple illustration may be taken.

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A and B agree that a debt of say £15,000, which the one owes to the other, shall be settled twenty years hence by means of one payment of £25,000. In such a case the present value of the £25,000 may reasonably be taken to be £15,000, and I see no reason for treating the asset as being worth £25,000 at the moment when the bargain is made. Clearly it has no such real value.

The position, however, of a debt payable in the future which bears interest meanwhile is another matter. The parties are free to arrange what interest will recompense the lender for the delay in payment, and *prima facie* what they arrange does represent the proper payment for that delay. It might, no doubt, be shown that it is only nominally arranged for that purpose and that in reality it is too large or too small, but such cases must be rare, and as a rule it is a true evaluation of the amount to be paid in return for the postponement.

There may be a number of reasons for valuing a debt at less than its face value, and were it not for Rule 3 (*i*) I should regard the proper course in cases like the present to be to write down the value of the individual debt in accordance with the many risks of its not being paid which so long a postponement and so unsubstantial a debtor would involve.

But though other eventualities may be taken into account in ascertaining the value of a debt, Rule 3 (*i*), in forbidding an allowance to be made for anything other than bad or doubtful debts to the extent to which they are estimated to be bad, does, I think, imply that badness or doubtfulness which is not actually existent at the time the estimate had to be made, but is then only a future possibility, should not be taken into consideration. Any delay in payment is made up for by the agreed interest, and for the moment it cannot be said that any of the debts in issue are, or can presently be, estimated to be bad or doubtful. Indeed it has not been suggested that any allowance should be made in the present case on those grounds and except for the delay I know of no contingency, other than that the debts may at some time become bad or doubtful, which would call for a reduction.

Cronk's case(1) dealt with a different set of circumstances. In it no debt remained due from the purchaser to the owner, the full price was paid to the latter by the building society. But lest the society should not be repaid by the purchaser in full, the owner deposited a sum of money with it and guaranteed payment of an additional sum beyond the deposit. In these circumstances there were contingent liabilities on each side: in the case of the society to return the deposit or some part of it, if the money which was recovered from the purchaser enabled this to be done: on the side of the owner to implement his guarantee if the purchaser failed to pay even so much as with the deposit made up the full price. The amount of the liability on either side was not an ascertainable figure and could at best be estimated and perhaps only guessed. In these circumstances your Lordships decided that if it could be estimated, the liability of the building society should be brought into account in the year in which it was incurred. But if it could not be estimated, any sum found to be due from the society to the owner must be treated as an asset in the year in which it was ultimately paid. In such a case there was no debt either present or future due to the Appellant. It might eventually happen that something would be found to be due to him but, on the other hand, so far from receiving, he might have to pay. I do not see how such a contingent liability could be treated as having its largest possible value, when it might have none; and that, not because the liability was a debt and was bad or doubtful, but because there might be no liability at all.

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(1) 20 T.C. 612.

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John Emery & Sons v. *Commissioners of Inland Revenue,* [1937] A.C. 91; 20 T.C. 213, on which the Appellant also relied, did not bring in issue any question of the value of a debt. There was no personal obligation in that case, only a ground annual, that is, a perpetual annuity of a fixed sum secured upon property. Such an annuity was not money but money's worth; it had an ascertainable value in cash, and was in your Lordships' view to be taken into account at that value. Neither case seems to me to throw much light upon the question which your Lordships have to consider.

If the face value of a debt once taken were final, it might be said that an injustice had been done to the owner, who would be accountable for the full value, and yet, if his experience (for example, in the present case) was to be trusted, might lose as much as a third part of the debts which had been treated in his accounts as having their full face value.

Your Lordships' attention, however, has been drawn to the practice in the past of the Inland Revenue authorities of making an allowance in respect of losses for bad or doubtful debts as and when they occur, though the debt itself was originally treated as being of its face value in a previous year's accounts. Such a practice necessitates, I think, the corresponding obligation on the part of the taxpayer to submit in a later year to an increase in the sum at which a debt previously treated as bad or doubtful should be brought into account if in fact a payment greater than the assumed value had been obtained or seems likely to be obtained, on a later occasion.

In *Anderton and Halstead, Ltd.* v. *Birrell,* [1932] 1 K.B. 271; 16 T.C. 200, a debt taken into account in a previous year was later permitted to be written down in two stages in two successive years. The decision in that case turned upon a different point, namely, whether the debt could be treated as having been mistakenly valued at too low a figure in the years in which the value had been written down, so that the profits of those years could be re-calculated, the value written up, and the sum, upon which tax was payable, increased. The argument that it could be so treated was held to be unsound, but nothing was said to throw doubt upon the right of the subject to have the value of a debt reduced at any time as and when it was discovered to be bad or doubtful, or of the Crown to have it increased in some future year, if it proved to be of greater value than had been assumed in an earlier year when it was brought into account or valued.

A course similar to that followed in *Anderton's* case seems to have been adopted in *Reid's Brewery Co., Ltd.* v. *Male,* [1891] 2 Q.B. 1; 3 T.C. 279; and I know of no decision to the contrary which binds the Court of this country.

In the submission of the Crown this practice is justified under the terms of Rule 3 (*i*). It has been argued, however, that the wording of this Rule permits a deduction from the face value of a debt only in the year in which it is brought into account. Thereafter, it is said, its value can no longer be altered. An opinion to this effect is to be found in *Gleaner Co., Ltd.* v. *Assessment Committee,* [1922] 2 A.C. 169. That case depends upon the wording of the Jamaica Income Tax Acts, and though the language used is similar to the wording of the English Acts, yet the case itself, being a decision of the Privy Council, is not binding upon your Lordships, and in any case the view expressed in it has always been regarded with some doubt so far as concerns this country—see Halsbury (Hailsham edition), Volume XVII, page 162, note (*t*).

Apart from that case I know of no reason for limiting the effect of the Rule to one year. In my view the practice of the Income Tax authorities

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has statutory warrant, and the correct course to pursue in cases like the present is to treat the debt as good until it is shown to be bad or doubtful. And when it is so shown to make an allowance in the year in which its diminution in value is thus justified. Admittedly, so much of the sum as consists of interest must be separately accounted for as and when each portion becomes due.

No doubt if this course be followed and if a building owner goes out of business, he may suffer some hardship inasmuch as there is in that case no future year in which he can be given an allowance in cases where the debt proves bad or doubtful after his business activities have ceased. On the other hand if a debt has been written down before he retires and is afterwards paid in full, he will receive a windfall in the shape of a payment which is subject to no tax.

However that may be, I find myself in agreement with the noble Viscount on the Woolsack, and would dismiss the appeal in the present case for the reasons set out above, which are not dissimilar to, though not quite identical with, those which influenced the Court of Appeal.

Questions put:

That the Order appealed from be reversed.

The Contents have it.

That the Cause be remitted to the Special Commissioners with a direction to make a valuation and to vary the assessments in accordance with the opinion expressed in this House, and that the Respondent do pay to the Appellant his costs before the Special Commissioners[1], in the Courts below and in this House.

The Contents have it.

[Solicitors:—Helder, Roberts, Giles & Co.; Claude Barker & Partners; Solicitor of Inland Revenue.]

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[1] The Order was in the following terms:—" It is Ordered and Adjudged . . . that the Cause " be and the same is hereby remitted back to the Commissioners for the Special Purposes " of the Income Tax Acts with a Direction to make a valuation and to vary the " assessments in accordance with the opinion expressed in this House: And it is further " Ordered, That the Respondent do pay, or cause to be paid, to the said Appellant the " Costs incurred by him in respect of the Appeal to the Commissioners for the Special " Purposes of the Income Tax Acts on remission and in the Courts below, and also the " Costs incurred by him in respect of the said Appeal to this House, the amount of such " last-mentioned Costs to be certified by the Clerk of the Parliaments . . ."