

No. 547.—HIGH COURT OF JUSTICE (KING'S BENCH DIVISION).—
27TH JUNE, 1924.

COURT OF APPEAL.—3RD AND 4TH NOVEMBER, 1924.

HOUSE OF LORDS.—28TH JANUARY AND 4TH AND 26TH FEBRUARY,
1926.

THE COMMISSIONERS OF INLAND REVENUE v.
FISHER'S EXECUTORS.⁽¹⁾

Super-tax—Total income—Debenture stock created and distributed to shareholders by limited company in satisfaction of bonus declared out of undivided profits—Finance. (1909–10) Act, 1910 (10 Edw. VII, c. 8), Section 66.

Under the authority of its Articles of Association as amended for the purpose, a limited company resolved that part of its undivided profits should be capitalised and distributed as a bonus, and created and issued 5 per cent. debenture stock to its ordinary shareholders in satisfaction of such bonus, the shareholders having no option to receive cash in lieu of the stock. In order that the position of the preference shareholders might be in no way prejudiced, arrangements were at the same time made under which the whole of the preference shares were acquired by the ordinary shareholders in exchange for a corresponding amount of the debenture stock.

Except in certain events the debenture stock was not redeemable in less than six years from the date of issue.

Held, that the bonus paid to the ordinary shareholders in debenture stock was not a distribution of profits, and did not constitute income in their hands for the purposes of Super-tax.

The Commissioners of Inland Revenue v. Blott (8 T.C. 101) followed.

CASE

Stated under the Income Tax Act, 1918, Sections 7 (6) and 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 2nd November, 1922, for the purpose of hearing appeals, the Executors of the Right Rev. G. C. Fisher appealed against an additional assessment to Super-tax in the sum of £82,500 for the year ending 5th April, 1916, made upon the Right Rev. G. C. Fisher under the provisions

⁽¹⁾ Reported K.B.D. and C.A., [1925] 1 K.B. 451, and H.L., [1926] A.C. 395.

of the Income Tax Acts in respect of a bonus received by him from the Wearmouth Coal Company, Limited, in the year 1914-15 as hereinafter described.

2. In the balance sheet of the Wearmouth Coal Company, Limited (hereinafter called the Company), at 31st December, 1913, appeared the following items of undistributed profit :—

Amount standing to credit of Profit and	£	s.	d.
Loss Account	167,279	2	0
Reserve Fund	293,035	14	11
Royalty Rent Suspense Account ...	14,502	12	1

3. On the 25th March, 1914, the Directors of the Company being of opinion that part of these undistributed profits should be capitalised by a distribution of debenture stock to the ordinary shareholders, the following circular letter was issued to the shareholders :—

“ I am instructed to inform you that the Directors being
 “ of opinion that the reserve funds and undivided profits of
 “ the Company, which as you will perceive from the
 “ Balance Sheet are of large amount and which have been
 “ to a great extent expended in increasing the capital value
 “ of the Company's property, should be capitalised and
 “ secured to the shareholders, have determined to take the
 “ necessary steps to effect the capitalisation of £357,500 of
 “ these reserve funds by distributing this amount *pro rata*
 “ amongst the ordinary shareholders in the form of a 5 per
 “ cent. debenture stock.

“ Having regard to the fact that those members of the
 “ Company who only hold preference shares or whose hold-
 “ ing of preference shares is greater than their holding of
 “ ordinary shares may consider that the creation of deben-
 “ ture stock may be prejudicial to them, the Directors pro-
 “ pose as part of their scheme that arrangements should be
 “ made by which the whole of the preference shares shall
 “ be acquired by the ordinary shareholders in exchange for
 “ a corresponding amount of debenture stock.

“ Those members therefore whose interest in the Com-
 “ pany is that of preference shareholders rather than ordinary
 “ shareholders will thus obtain the advantage of receiving
 “ a 5 per cent. debenture stock in lieu of their 5 per cent.
 “ preference shares and the benefit of this will be so obvious
 “ to them that the Directors think that any further explana-
 “ tion is unnecessary.

“ I therefore beg to send you herewith a formal notice
 “ convening the first of the special meetings of the share-
 “ holders which will be necessary for the purpose of making
 “ such alterations in the Articles of Association as are
 “ required to enable the proposed scheme to be carried out.

“ This resolution must be confirmed at a subsequent
 “ extraordinary meeting of the shareholders and before this
 “ meeting is held the necessary agreement or agreements
 “ providing for the exchange of debenture stock for prefer-
 “ ence shares will be sent to you for your signature so that
 “ in the event of the resolution being subsequently confirmed
 “ the agreements would thereupon become operative.

“ In case you are unable to attend the meetings on the
 “ 3rd April personally, I beg to enclose herewith a form of
 “ proxy for your signature which please sign and return to
 “ me not later than the 31st instant.”

4. Enclosed with the circular letter of the 25th March was a Notice of an Extraordinary General Meeting of the Company to be held on the 3rd April, 1914, for the purpose of considering and, if approved, adopting the following Resolution as an Extraordinary Resolution :—

RESOLUTION.

“ That the Articles of Association of the Company be
 “ altered in manner following :—

(a) By inserting in Article 42 after the words ‘ or other persons ’ the words ‘ or secure the payment of ’ and by substituting in that Article for the figure ‘ £50,000 ’ the figure ‘ £500,000.’

(b) By striking out in Article 43 the words ‘ the repayment of such moneys ’ and inserting in lieu thereof the words ‘ the payment or repayment of ’ the moneys borrowed or to be borrowed or the ‘ payment whereof is to be secured ’ and by inserting in the same Article after the word ‘ Debentures ’ wherever it occurs the words ‘ or ‘ Debenture Stock ’ and after the words ‘ or in ‘ payment of debts ’ the words ‘ or in satisfac- ‘ tion of any bonus payable out of the reserve ‘ funds or other undivided profits of the ‘ Company.’

(c) By inserting after Article 123 the following new Article :—

“ 123A.—(1) The Company in General Meeting may in
 “ the year 1914 pass a Resolution to the effect that it is
 “ desirable to capitalise the sum of £357,500, being part of
 “ the undivided profits of the Company standing to the
 “ credit of the Reserve Fund, Royalty Rent Suspense
 “ Account, and Profit and Loss Account for the year ending
 “ 31st December, 1913, and accordingly that that sum be
 “ distributed as a bonus among the holders of the ordinary
 “ shares in proportion to the amount paid up or credited
 “ as paid up on the ordinary shares held by them respectively.

“(2) When such Resolution has been passed the Directors may create and issue to the holders of the ordinary shares in proportion to the amount paid up or credited as paid up on the ordinary shares held by them respectively, debenture stock of the Company of the nominal amount of £357,500 in satisfaction of the said bonus, and any debenture stock so issued shall be accepted by the person or persons to whom the same is issued in satisfaction of the bonus payable to him or them.

“(3) It shall be no objection to Resolutions passed under paragraph (1) of this Article, that they are passed at the Meeting at which the resolution introducing this Article is confirmed as a Special Resolution, provided that due notice of the intention to propose such first-mentioned Resolutions shall have been given prior to the confirmatory meeting aforesaid.”

5. This Resolution having been passed on the 3rd April, 1914, as an Extraordinary Resolution, the Company issued on the 20th April, 1914, the following letter to the Shareholders:—

“Referring to my circular letter of the 25th March I am now instructed by the Directors to inform you, that the Extraordinary Resolution providing for the alteration of the Articles of Association of the Company, which is necessary to enable the Directors to carry out the capitalisation of Reserve Funds explained in my letter, was unanimously passed by the shareholders at their Meeting on the 3rd instant, and I now send you herewith a notice convening the Second Extraordinary Meeting for the purpose of confirming the Resolution as a Special Resolution.

“I also send you herewith a print of the Agreement providing for the exchange of debenture stock for preference shares, which you can retain for your own use and with the print I send you a printed form of authority authorising Mr. Frank Stobart, or Mr. H. M. Stobart, as the case may be, to sign the Agreement as the representative of the particular class of shareholders concerned, and I shall feel obliged by your being good enough to return this form of authority to me signed, at your earliest convenience, so that as soon as I have obtained from the required number of shareholders authorities to the same effect, the Messrs. Stobart will be in a position to sign the Agreements and carry out the transaction.

“I also enclose a notice convening a separate meeting of the holders of the preference shares of the Company to be held immediately on the conclusion of the General Meeting for the purpose of recording separately, as required by Article 48 of the Articles of Association, the

“sanction of the preference shareholders as a class to the
 “creation of the proposed debenture stock and to its distri-
 “bution by way of a bonus.

“In case you are unable to attend the meetings on the
 “29th April personally, I beg to hand you herewith forms
 “of proxy for your signature, which please sign and return
 “to me not later than the 27th instant.”

(Note.—Where a shareholder did not hold any preference shares the third paragraph of this letter was crossed out.)

6. A copy of the Agreement (marked A) referred to in the letter of the 20th April, 1914, is attached and forms part of this Case⁽¹⁾. The Agreement was executed on the 28th April, 1914. A copy of the Memorandum and Articles of Association of the Company (marked B)⁽¹⁾ and of the Balance Sheets of the Company for the years 1913 and 1914 (marked C and D) are also attached and form part of this Case.

7. On the 29th April, 1914, the Resolution set out in paragraph 4 of this Case was duly confirmed as a Special Resolution and filed with the Registrar of Companies on the 2nd May, 1914.

8. On the 12th May, 1914, the following Notice was issued by the Company to its Ordinary Shareholders:—

“NOTICE IS HEREBY GIVEN that an Extraordinary General
 “Meeting of the members of the Wearmouth Coal Com-
 “pany, Limited, will be held at the Registered Office of
 “the Company, Monkwearmouth, on Thursday, the 21st
 “day of May, 1914, at 3 o'clock in the afternoon for the
 “purpose of considering, and, if approved, adopting the
 “subjoined Resolution.

RESOLUTION.

“That it is desirable to capitalise the sum of
 “£357,500 being part of the undivided profits of the
 “Company standing to the credit of the Reserve Fund,
 “Royalty Rents Suspense Account, and Profit and
 “Loss Account for the year ending 31st December,
 “1913, and accordingly that that sum be distributed
 “as a bonus among the holders of the ordinary shares
 “in proportion to the amounts paid up or credited as
 “paid up on the ordinary shares held by them
 “respectively.”

“For your information it may be explained that after
 “the above Resolution has been passed the Directors will
 “take the necessary steps to create and issue to the holders
 “of the ordinary shares, debenture stock of the Company
 “of the nominal amount of £357,500 in satisfaction of the
 “bonus as provided by paragraph 2 of Article 123A of the
 “Articles of Association of the Company.”

⁽¹⁾ Exhibits A and B are omitted from the present print.

9. At the same time a Notice was issued to the holders of preference shares in the Company in the following terms :—

“ NOTICE IS HEREBY GIVEN that a separate General Meeting of the holders of the preference shares of the Wearmouth Coal Company, Limited, will be held at the registered office of the Company, Monkwearmouth, on Thursday, the 21st day of May, 1914, at 3.15 o'clock in the afternoon or as soon thereafter as the business of the Extraordinary General Meeting of all the members of the Company to be held on that day shall have concluded, for the purpose of considering and, if approved, adopting the subjoined Resolution as an Extraordinary Resolution.

RESOLUTION.

“ That the following Resolution passed at the Extraordinary General Meeting of all the members of the Company held on the 21st day of May, 1914, be and is hereby sanctioned by the holders of the preference shares of the Company that is to say :—

“ That it is desirable to capitalise the sum of £357,500 being part of the undivided profits of the Company standing to the credit of the Reserve Fund, Royalty Rents Suspense Account, and Profit and Loss Account for the year ending 31st December, 1913, and accordingly that that sum be distributed as a bonus among the holders of the ordinary shares in proportion to the amounts paid up or credited as paid up on the ordinary shares held by them respectively.

“ For your information it may be explained that after the above Resolution has been passed the Directors will take the necessary steps to create and issue to the holders of the ordinary shares, debenture stock of the Company of the nominal amount of £357,500 in satisfaction of the bonus as provided by paragraph 2 of Article 123A of the Articles of Association of the Company.”

10. On the 21st May, 1914, the Resolution set out in paragraphs 8 and 9 above were duly passed, and on the 30th June, 1914, a circular letter was sent by the Company to each shareholder. There were three variants of this letter but only one was sent to each shareholder :—

- (a) the first form of the letter was sent to those shareholders (including the Right Rev. G. C. Fisher) who had to part with some of their bonus in exchange for preference shares;
- (b) the second to those who in addition to their bonus received debenture stock in exchange for preference shares.

(c) the third was sent to those who held preference shares only and who received debenture stock in exchange for those shares.

11. The letter sent to the Right Rev. G. C. Fisher was in the following terms :—

“ The necessary Resolutions authorising the creation of debenture stock, and the distribution of a bonus in the form of debenture stock to the amount of £357,500 having been duly passed by the shareholders, the Directors of the Wearmouth Coal Company, Limited, will proceed at their next meeting to issue the stock.

“ The exchange of debenture stock for preference shares provided for by the Agreement dated the 28th April, 1914, which has been signed on your behalf under the authority given by you will take effect as from 1st July, 1914, the present preference shareholders receiving the preference dividend of 5 per cent. to June 30th, and becoming entitled to interest on their debenture stock at the rate of 5 per cent. from the 1st July.

“ Your proportion of the bonus is £82,500 in respect of which you are to receive under the terms of the Agreement, debenture stock amounting to £65,960 and 3,308 preference shares of £5 each of the total nominal value of £16,540, together amounting to £82,500.

“ In case you wish any part or all of this debenture stock and/or preference shares to be registered in the name of some nominee or nominees, I enclose a form of direction which please fill up, sign, and return to me not later than 15th July next.

“ If you do not return this form by that date I shall assume that you wish to have the debenture stock and preference shares registered in your own name and I shall have the debenture stock certificate and the preference share transfers prepared accordingly.”

12. In the case of those who in addition to their bonus received further debenture stock in exchange for preference shares the third paragraph of the above letter read as follows :—

“ Your proportion of the bonus receivable in debenture stock is £ in addition to which you are entitled to debenture stock in exchange for preference shares amounting to £ making a total amount of debenture stock to be issued to you of £ .”

In the case of those who held preference shares only the third paragraph read :—

“ The amount of debenture stock to be received by you in exchange for preference shares is £ .”

13. On the 31st July, 1914, the debenture stock trust deed (a copy of which, marked E, is annexed and forms part of this Case⁽¹⁾) was executed and the debenture stock was duly issued.

The debenture stock became repayable in each and every of the events mentioned in Clause 10 of the said deed⁽²⁾.

The conditions of issue of the said debenture stock were contained in the first schedule of the said debenture stock trust deed, and under such conditions the stock was redeemable as follows:—

- (a) At any time after the 1st day of January, 1920, the Company might from time to time on giving six calendar months' notice in writing redeem the stock or any part thereof not being less at any one time than one-twentieth part of the amount of the stock for the time being outstanding;
- (b) should the Company at any time before the said 1st day of January, 1920, sell its undertaking it was to redeem the whole of the stock;
- (c) whenever the Company at any time before the 1st day of January, 1920, sold any section of its undertaking it was to redeem a portion of the stock equal in amount to not less than one half of the purchase money of such section;
- (f) any of the stock not previously redeemed was to be redeemed at par when and so soon as the security hereby constituted became enforceable and the redemption price was to be par.

14. The Right Reverend G. C. Fisher held 14,400 ordinary shares of £5 each, of which 12,000 were fully paid and in respect

(1) Omitted from the present print.

(2) Clause 10 of the trust deed read as follows:—

The security hereby constituted shall become enforceable in each and every of the events following (that is to say):—

- (1) If the Company shall make default in the payment of any interest which ought to be paid in accordance with these presents.
- (2) If an order shall be made or an effective resolution shall be passed for the winding up of the Company.
- (3) If a receiver of the Company's undertaking or any part thereof shall be appointed and such appointment shall in the opinion of the Trustees or Trustee be prejudicial to the security hereby constituted.
- (4) If a distress or execution be levied or enforced upon or against any of the property of the Company.
- (5) If any execution extant or other process of any Court or Authority is issued out against the mortgaged premises or any part thereof for any sum whatever.
- (6) If default shall be made by the Company in the performance or observance of any covenant, condition or provision binding on the Company under these presents.
- (7) If the Company shall stop payment or shall without the assent in writing of the Trustees or Trustee cease to carry on its business or threaten to cease to carry on the same.

of 2,400 of which £2 10s. only was paid, and also held 7,640 preference shares of £5 each, all fully paid. In virtue of his holding of ordinary shares he became entitled as his share of the bonus to £82,500 of debenture stock, of which in accordance with the Agreement of the 28th April, 1914, £16,540 had to be parted with in exchange for a corresponding amount of fully paid preference shares, with the result that £65,960 debenture stock was retained. He did not receive, nor was he entitled to receive, any payment in cash in respect of his share of the bonus, and the net result was (as appears in the First Schedule to the said Agreement of April 28th, 1914) that he retained his 14,400 ordinary shares as aforesaid, obtained as above described 3,308 preference shares from preference shareholders and so held 10,948 preference shares instead of 7,640, and also received £65,960 in the debenture stock of the Company.

15. It was contended by Counsel for the Respondents:—

- (a) that the debenture stock was distributed to persons who were entitled to the assets of the Company;
- (b) that the bonus was declared in such terms as ensured that the profits should remain in the hands of the Company;
- (c) that the Company parted with none of its assets by the distribution;
- (d) that the case was indistinguishable in principle from the case of *The Commissioners of Inland Revenue v. Blott*⁽¹⁾, [1921] 2 A.C. 171;
- (e) that the additional assessment appealed against should be discharged.

16. On behalf of the Crown it was contended (*inter alia*):—

- (a) that there was a liberation of assets and a distribution of profits by the Company to the ordinary shareholders and that the amount received by them was income in their hands;
- (b) that there was a distinction between a debenture stockholder and a shareholder in that the former was a creditor of the Company;
- (c) that the case was not governed by the decision in the case of *The Commissioners of Inland Revenue v. Blott*⁽¹⁾;
- (d) that the bonus distribution was income to the recipient and was liable to assessment to Super-tax.

17. We, the Commissioners who heard the appeal, held that the bonus paid in debenture stock was not income in the hands of the recipient and was not liable to Super-tax. We therefore discharged the additional assessment under appeal.

18. If the Court decides that the bonus in question is not income liable to Super-tax it is agreed that the assessment should

(¹) 8 T.C. 101.

be discharged. If, on the other hand, the Court decides that the bonus is income liable to Super-tax, it is agreed that the Case shall be remitted to the Commissioners to decide the amount of the assessment.

19. The Appellants immediately upon the determination of the appeal declared to us their 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, Sections 7 (6) and 149, which Case we have stated and do sign accordingly.

H. M. SANDERS,
J. JACOB,

Commissioners for the Special Purposes
of the Income Tax Acts.

York House,
23, Kingsway, London, W.C.2.
25th April, 1924.

BALANCE SHEET OF THE WEARMOUTH COAL

		LIABILITIES.					
CAPITAL, VIZ :—							
AUTHORIZED—							
		£	s.	d.	£	s.	d.
	62,560 Ordinary Shares of £5 each ...	312,800	0	0			
	60,000 5% Preference Shares of £5 each	300,000	0	0			
	<u>122,560</u>	<u>612,800</u>	<u>0</u>	<u>0</u>			
ISSUED—							
	52,000 Ordinary Shares of £5 each, fully paid ...	260,000	0	0			
	10,400 do. do. upon which £2 10s. per Share has been called up and paid ...	26,000	0	0			
	47,440 5% Preference Shares of £5 each, fully paid ...	237,200	0	0			
					<u>523,200</u>	<u>0</u>	<u>0</u>
CREDITORS—							
	For Royalty and other Rents ...	27,252	0	9			
	Tradesmen and others ...	7,227	12	7			
					<u>34,479</u>	<u>13</u>	<u>4</u>
SUSPENSE ACCOUNT—							
	Provision for accrued Charges, less proportion of Charges paid in advance ...				6,433	2	6
	ROYALTY RENT SUSPENSE ACCOUNT ...				14,502	12	1
RESERVE FUND—							
	As on 31st December, 1912 ...	273,224	14	7			
	Special Reserve Account ...	25,000	0	0			
	Interest on Investments received during the year... ..	5,653	18	6			
		<u>303,878</u>	<u>13</u>	<u>1</u>			
	Less—Amount paid during the year in respect of Subsidence Claims and Costs	10,842	18	2			
					<u>293,035</u>	<u>14</u>	<u>11</u>
"C" PIT SINKING ACCOUNT—							
	As on 31st December, 1912 ...	9,889	16	6			
	Less—Amount expended during the year	2,436	6	7			
					<u>7,453</u>	<u>9</u>	<u>11</u>
PROFIT AND LOSS ACCOUNT—							
	Balance to Credit				167,279	2	0
					<u>£1,046,383</u>	<u>14</u>	<u>9</u>

REPORT OF THE AUDITORS TO THE SHAREHOLDERS

We have audited the Balance Sheet of the Wearmouth Coal Company, We have obtained all the information and explanations we have required. In our opinion such Balance Sheet is properly drawn up so as to exhibit the best of our information and the explanations given us, and as shown certified by the Company's Officials.

The Investments are valued at market price at 31st December, 1913.

Signed—T. C. SQUANCE & SONS,

Chartered Accountants,

Sunderland, 26th February, 1914.

AUDITORS.

" C "

COMPANY, LIMITED, FOR THE YEAR 1913.

				ASSETS.			
				£	s. d.	£	s. d.
WEARMOUTH COLLIERY	...	...	...	218,426	16 8		
HYLTON COLLIERY	...	...	...	286,521	12 9		
				<hr/>		504,948	9 5
LAND, COTTAGES, &C.—							
Wearmouth	...	...	...	77,074	10 11		
Hendon	...	...	...	46,266	19 9		
Hylton	...	...	...	59,558	15 8		
Chester Road Property	...	...	...	4,199	11 8		
				<hr/>		187,099	18 0
HYLTON CASTLE ESTATE—							
Cost	...	...	...	95,000	0 0		
Less—Transfer from Hylton Castle Estate, Current Account—							
This Year	...	1,633	7 4				
Previously	...	12,514	13 9				
				<hr/>		14,148	1 1
						80,851	18 11
STOCKS	...	...	...			5,176	15 5
INVESTMENTS	...	...	...			97,768	8 3
ROYALTY RENTS PAID IN ADVANCE	...					8,118	4 9
DEBTORS	...	...	...			55,594	3 4
CASH—							
AT BANKERS—							
On Deposit Account	...	85,000	0 0				
On Current Account	...	21,636	12 10				
				<hr/>		106,636	12 10
IN HAND	...	...	...			189	3 10
				<hr/>		106,825	16 8
						£1,046,383	14 9
						<hr/>	<hr/>

OF THE WEARMOUTH COAL COMPANY, LIMITED.

Limited, dated the 31st day of December, 1913, as set forth above.

a true and correct view of the state of the Company's affairs, according to by the books of the Company. The Stocks have been taken and are

Signed—FRANK STOBART, }
 HUGH M. STOBART, } Directors.

EXHIBIT

BALANCE SHEET OF THE WEARMOUTH COAL

CAPITAL, VIZ. :—		LIABILITIES.					
AUTHORIZED—		£	s.	d.	£	s.	d.
62,560	Ordinary Shares of £5 each ...	312,800	0	0	£	0	0
	60,000 5% Preference Shares of £5 each	300,000	0	0	£	0	0
122,560		612,800	0	0			
ISSUED—							
52,000	Ordinary Shares of £5 each, fully paid	260,000	0	0			
10,400	do. do. upon which £2 10s. per Share has been called up and paid	26,000	0	0			
47,440	5% Preference Shares of £5 each fully paid	237,200	0	0			
					523,200	0	0
5% DEBENTURE STOCK—							
	AUTHORIZED	500,000	0	0			
	ISSUED				357,500	0	0
CREDITORS—							
	For Royalty and other Rents	21,805	6	0			
	Tradesmen and others	7,007	12	4			
					28,812	18	4
SUSPENSE ACCOUNT—							
	Provision for accrued Charges, less proportion of Charges paid in advance ...				8,696	17	3
	ROYALTY RENT SUSPENSE ACCOUNT ...				15,535	8	7
RESERVE FUND—							
	As on 31st December, 1913	293,035	14	11			
	Transfer from Profit and Loss Account	64,464	5	1			
		357,500	0	0			
	Less—Bonus distributed July, 1914, in the form of Debenture Stock ...	357,500	0	0			
SPECIAL RESERVE ACCOUNT—							
	Amount set aside out of Profits ...	85,000	0	0			
	Less—Amount paid during the year in respect of Subsidence Claims and Costs	20,661	3	4			
					64,338	16	8
"C" PIT SINKING ACCOUNT—							
	As on 31st December, 1913	7,453	9	11			
	Less—Amount expended during the year	615	10	8			
					6,837	19	3
PROFIT AND LOSS ACCOUNT—							
	Balance to Credit				38,067	14	8
					£1,042,989	14	9

REPORT OF THE AUDITORS TO THE SHAREHOLDERS

We have audited the Balance Sheet of the Wearmouth Coal Company, We have obtained all the information and explanations we have required. The Investments appear in the Balance Sheet at the market prices of In our opinion such Balance Sheet, subject to the Depreciation of correct view of the state of the Company's affairs, according to the best of of the Company. The Stocks have been taken and are certified by the

Signed—T. C. SQUANCE & SONS, Chartered Accountants,
Sunderland, 8th March, 1915. AUDITORS.

The case came before Rowlatt, *J.*, in the King's Bench Division on the 27th June, 1924, when judgment was given in favour of the Crown, with costs.

The Attorney-General (Sir Patrick Hastings, K.C., M.P.) and Mr. R. P. Hills appeared as Counsel for the Crown, and Mr. A. M. Latter, K.C., and Mr. Cyril King for the Respondent.

JUDGMENT.

Rowlatt, J.—I do not think I need trouble you any further, Mr. Attorney; I have made up my mind on this case, and it is much better that I should deliver my judgment now. It is an important case—very; but I am bound to say I think it is not a difficult one. The Company had an enormous sum of undivided profits and it issued to its ordinary shareholders debenture stock in respect of these profits. It was one of the terms of the issue that they should buy out the preference shareholders. The Company purported on terms to capitalise these profits, but that is not a true description. Capitalising profits means as in *Blott's* case⁽¹⁾ that the proprietary capital of the Company is increased. Here they only capitalised the profits in this sense, that, as Mr. Latter says, they impounded them and kept them for their use. It was contended for the Respondents that the Company recognised that the profits belonged to the shareholders *pro rata*, and they secured the shareholders in their right to the profits by issuing the debenture stock, which was not payable at the instance of the shareholders at all, but could only be enforced by the shareholders if certain events happened, and therefore, that was not a payment of dividend at all. The shareholders, of course, were put in a very different position by the receipt of the stock; they got, to begin with, a right to call for the amount of their share of the undivided profits preferentially to any outside creditors if the Company was wound up. The result to the Company was that no longer would there appear in their balance sheet this great preponderance of undivided profits, because against them there would stand the securities which had been issued. It seems to me that when you issue a security upon your property, which sooner or later has to be realised, you are putting in the hands of the person to whom you issue it part of the property—not physically for the moment, but you are giving him part of the value, in substance. Now under those circumstances it seems to me that this was the creation of a security, a security worth money, and they issued it to their shareholders by way of giving them at once their share of these undivided profits. It seems to me that this stock may bear interest at a rate which will make it worth more than its face value, on the other hand it may be worth less than its face value; I do not want to decide a question that is not before me, but I want to guard myself against being thought to have said that

(1) *Commissioners of Inland Revenue v. Blott*, 8 T.C. 101.

(Rowlatt, J.)

necessarily the face value of the debenture stock is the measure of the tax which I think the Respondents must pay. I, therefore, allow the appeal of the Crown with costs.

The Attorney-General.—Your Lordship will allow this appeal?

Rowlatt, J.—Yes, and remit the case for the amount to be assessed.

The Attorney-General.—If your Lordship pleases.

An appeal having been entered against the decision in the King's Bench Division, the case came before the Court of Appeal (Pollock, *M.R.*, and Warrington and Scrutton, *L.JJ.*) on the 3rd and 4th November, 1924, when Mr. A. M. Latter, *K.C.*, and Mr. Cyril King appeared as Counsel for the Executors, and the Attorney-General (Sir Patrick Hastings, *K.C.*, *M.P.*) and Mr. R. P. Hills for the Crown.

On the latter day judgment was given against the Crown, with costs, reversing the decision of the Court below.

JUDGMENT.

Pollock, M.R.—This is an appeal from a decision of Mr. Justice Rowlatt who set aside the decision of the Commissioners for Special Purposes of the Income Tax Acts. The case is this: The executors of the late Bishop Fisher appealed against an additional assessment to Super-tax made upon them in the sum of £82,500 for the year ending the 5th April, 1916, made in respect of a bonus received by him from the Wearmouth Coal Company, Limited, in the year 1914-15. It appears that the late Bishop Fisher had held some ordinary shares and also, I think, some preference shares in the Wearmouth Coal Company, Limited, and that Company had been for a time prosperous, with the result that on the 31st December, 1913, in the Company's balance sheet there appeared a sum standing to the credit of profit and loss account of £167,279, there was standing to the reserve fund £293,035 and to the royalty rent suspense account £14,502. The directors came to the conclusion that instead of leaving those undistributed profits as they stood it would be wise to make use of them and to deal with them in this manner,—in the creation of debenture stock, which debenture stock should be issued to the ordinary shareholders. Inasmuch as there were preference shareholders who would be entitled not only to their dividend in preference to the ordinary shareholders but to a preference on a distribution upon any winding-up of the Company, and that distribution of their capital might be prejudiced by the creation of a prior charge which would have a prior right if the capital ever had to be distributed, the Company determined that the best course would be to get rid of the preference shares altogether and so, by buying out the interest of the preference

(Pollock, M.R.)

shareholders, to leave the Company in the position of having ordinary shareholders only, with this debenture stock which would be owned by the ordinary shareholders; and on the 25th March, 1914, they wrote a letter to their shareholders saying that they had determined that these reserve funds and undivided profits, which were of the large amount which I have referred to, should be capitalised and secured to the shareholders, and they determined to take the necessary steps to effect the capitalisation of the total sum of £357,500 of these reserve funds, which is I think approximately the exact figure of the three sums which I have referred to before, by distributing this amount pro rata among the ordinary shareholders in the form of 5 per cent. debenture stock, and in the next paragraph they say that the creation of debenture stock may be prejudicial, for the reasons which I have given, to the holders of the preference shares, and, therefore, the whole of the preference shares are to be acquired by the ordinary stockholders in exchange for a corresponding amount of debenture stock. In the particular case of Bishop Fisher a letter was written to him informing him that the sum that he would be entitled to as his aliquot part of the debenture stock created would be the sum of £82,500, and that that sum would be used in this form: "You are to receive under the terms of the Agreement debenture stock amounting to £65,960 and 3,308 preference shares of £5 each," that being the number of the preference shares which it would fall to his lot to buy up and so cancel, which made the total nominal value of £16,540, and those two sums, the £65,960 of debenture stock which was to be out and out issued to him and the value of the preference shares which was £16,540, would together make the total sum of £82,500 which was the amount of the bonus, the aliquot portion of the distribution to be made to him out of the £357,500 of debenture stock created. That was carried out.

Now it is said by the Income Tax Authorities that in respect of this bonus, a bonus of debenture stock so received by the late Bishop Fisher, they are entitled to charge him with Super-tax. In order that they may charge him with Super-tax it has to be shown that what he has received is a part of his total income from all sources for the previous year estimated in the same manner as the total income from all sources is estimated for the purposes of exemption or abatement under the Income Tax Acts; and so the question is, is this bonus of debenture stock to which Bishop Fisher became entitled to be treated as a part of his total income for the year in which the charge is claimed to be made? I agree with Mr. Hills that we are not bound, and the Revenue Authorities are not bound, by the particular words which are used by the Company in informing their shareholders of what they are going to do. It does not matter that they say that they are embarking on a plan of capitalisation, nor that they are embarking on a plan of distribution if in fact what they

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do is not truly capitalisation or what they are doing is not truly distribution. One has to look in these tax cases, as Lord Cave says on page 201 of *Blott's case*⁽¹⁾, [1921] 2 A.C. 171, at the substance and not at the form of the transaction.

Now what was the substance of the transaction? Here I think it is important just for a moment to consider the balance sheet of the Company as it stood before this operation was carried out and afterwards. Before it was carried out the matter stood in this way: The balance sheet showed that there were these three items which I have already referred to, totalling £357,500, which represented profits or reserve funds. After the operation had been carried out the profits and reserve funds no longer find their place in that balance sheet, but they are now represented by debenture stock created. In other words, they have used those assets for the purpose of creating debenture stock and the money for that debenture stock is provided out of the profit and loss account and reserve funds. The debenture stock which has been created is money lent to the Company upon terms which make it repayable by the Company only at the particular period and on the terms and conditions which are laid down in the debenture deed. Now just for a moment looking at what has been done, if a part of the reserve fund or the profit and loss account were paid out to the shareholder simply as cash I think it would be clear that what had been paid to the shareholder was his aliquot part of profits, of income accumulated during a period of years and paid out to him as such. That was not what was done. What was done was that an offer was made to the shareholders obviously in their interest, that, instead of receiving cash paid to them, they should be given in a particular form something which thereafter would represent the amount standing to profit and loss account and to reserve funds; but it was given in a particular form only, and the form in which it was given was determined and determined finally by the Company itself. Now it is said that what the shareholder has received is a part of the profits which the Company previously held. As I have pointed out the Company determined, first of all, that those undivided profits should be used for a particular purpose, namely, the creation of debenture stock, and that thereafter that debenture stock when created should be given out to the shareholders not merely as debenture stock but debenture stock in a particular form used *pro tanto* for the swallowing up of the preference shares. The Commissioners who heard the appeal held that the bonus paid in debenture stock was not income in the hands of the recipient and was not liable to Super-tax. Mr. Justice Rowlatt has held that it was liable. I will say at once why I find myself unable to agree with his judgment. He refers to *Blott's case*⁽²⁾ and I must refer to

(1) The Commissioners of Inland Revenue v. Blott, 8 T.C. 101, at p. 135.

(2) 8 T.C. 101.

(Pollock, M.R.)

that in a moment. Mr. Justice Rowlatt says, "It seems to me that when you issue a security upon your property, which sooner or later has to be realised, you are putting in the hands of the person to whom you issue it part of the property—not physically for the moment, but you are giving him part of the value in substance. Now under those circumstances it seems to me that this was the creation of a security, a security worth money, and they issued it to their shareholders by way of giving them at once their share of these undivided profits." Now upon the facts found by the Commissioners I cannot agree with him that what has been issued was issued to the shareholders by way of giving them at once their share of these undivided profits. It appears to me from the findings of the Commissioners that they turned the undivided profits into a particular form which the shareholder could not question, and they gave him a part of the debenture stock created which did not give him at once a share of the undivided profits, but gave him a right in certain circumstances to call for the payment of the debenture stock if and when, according to the terms and conditions on which it was issued, they had a right to do so. The argument on behalf of the Crown may be compendiously said to be the argument which is put forcibly and very clearly by Lord Dunedin in his speech in *Blott's case*⁽¹⁾, but Lord Dunedin and Lord Sumner were dissentients from the judgment which was ultimately pronounced by the majority. It appears to me that the Commissioners have found, and rightly found, that what has been done is that the structure of the Company and the relation of the shareholder to that structure have been altered, while the Company and not the shareholder determined what that relation should be. No longer are there any undivided profits, no longer is there any reserve fund, but there are debenture holders. All that has been determined by appropriate and legal steps by the Company with its proper majorities. The Attorney-General argues that the shareholder was getting money's worth. So he did in the case of *Blott* where the bonus shares distributed were held to be a distribution of capital. But the Attorney-General says that where the shareholding of the shareholders is not affected, where the shareholder has the same aliquot share in the assets of the Company, then it is not a distribution of capital, but it is a distribution of profits. I do not think it is right to determine the case from the point of view of what is the shareholding of the shareholder. It may be that the shareholder would be entitled upon a liquidation to the same aliquot portion of the assets of the Company. But we have to look at it not from the point of view of Company Law, and I agree with Mr. Hills that we have not to look at it from the point of view of what ought to be the position between a tenant-for-life and remaindermen under a will or settlement such as had to be done in a number of cases to which he was prepared to refer; but we have to look at it from the point of view of Super-tax law and to

(¹) 8 T.C. 101.

(Pollock, M.R.)

see whether or not this portion of the debenture stock received by the late Bishop Fisher is a part of the total income estimated in the same manner as it would be estimated for Income Tax purposes. Now in *Blott's* case there was a distribution of shares. The shareholder was not given any option as to whether or not he would take shares or cash. The undistributed profits were used for the purpose of providing money represented by the shares, shares which the Company had a right to issue because they had not issued the total number of shares which they were entitled to do, and looking at the reasoning of *Blott's* case it seems to me the present case falls within it. In fact these undivided profits turned into the form of debenture stock do increase the available capital of the Company for its trading purposes. It may be used in any way the Company desire. As Lord Finlay points out in his speech in *Blott's* case on page 194⁽¹⁾, "No option was left to any particular shareholder. He was compelled by the action of the Company to take the preference shares." So, here, no option was left to the shareholder; he was compelled to take this particular debenture stock. "He could not," as Lord Finlay says, "have sued for the bonus in money, as the resolutions which gave the bonus *uno flatu* declared that it was to be satisfied by the distribution of the preference shares. Under these circumstances it seems to me impossible to treat the shareholders for the purpose of Super-tax as having received the bonus and paid it back to the Company to be retained as capital. They never received it at all." So, here, I do not think that Bishop Fisher received his aliquot portion of the undivided profits, and, as Lord Finlay says, "There can be no Super-tax upon income unless it has been received by the taxpayer." He also uses a phrase which I think is important⁽²⁾. "Instead of his getting any dividend, or anything in the nature of a dividend, the fund which might have been divided was impounded to increase the capital of the business." So here they might have distributed the undivided profits or the reserve fund, but instead of that the directors adopt and the Company agree to this particular method which ensures to the Company the use of this sum as capital and not otherwise. If there is a distribution or if there is allotted to him something in respect of which he can exercise a choice or volition it may be (I do not say it must be) income. But, as in *Blott's* case, so here the Company has the dominant voice in what it will give and in what form it will give the undivided profits to the shareholder. The shareholder himself has no voice at all, and when he receives what he does receive, he receives it not in the old form as it stood in the balance sheet of undivided profits or reserve fund, but in the particular form which he was compelled to acquiesce in owing to the conduct of the majority of the Company. Lord Cave says with regard to *Blott's* case at [1921] 2 A.C., page 200⁽³⁾:

(1) 8 T.C. at p. 132.

(2) *Ibid.* at p. 133.

(3) *Ibid.* at p. 135.

(Pollock, M.R.)

“ The transaction took nothing out of the Company’s coffers and put nothing into the shareholders’ pockets; and the only result was that the Company which before the resolution could have distributed the profit by way of dividend, or carried it temporarily to reserve, came thenceforth under an obligation to retain it permanently as capital.” So here there could have been a distribution of this sum, but instead of there being a distribution it was put into such a form that the Company now remain liable for the debenture stock in that form and will have to pay it as and when it becomes due. Looking therefore at the substance of the transaction, it appears to me that what has been done is that Bishop Fisher’s estate has been given something in a particular form which he was compelled to receive, a form different from the undivided profits that originally stood in the balance sheet, but a particular form which compelled him to stand as a creditor of the Company, a creditor for a capital sum due from the Company and in no sense the recipient of the original undivided profits.

For these reasons it seems to me that Mr. Justice Rowlatt’s decision is wrong and that the decision of the Commissioners ought to be restored, and the appeal allowed with costs.

Warrington, L.J.—I am of the same opinion.

In the year 1914 the late Bishop Fisher, who was an ordinary shareholder in the Wearmouth Coal Company, Limited, became entitled by virtue of certain resolutions of the Company to an allotment of £82,500 newly created debenture stock of the Company. The Crown contends that this £82,500 must be treated as income of Bishop Fisher and therefore be brought into account in assessing him to Super-tax. The Commissioners took the view that the sum in question was not income but was capital of the estate of the late Bishop Fisher, but their decision was reversed by Mr. Justice Rowlatt who came to a decision in favour of the Crown. This appeal is from Mr. Justice Rowlatt’s judgment.

Now, the real question is whether the Company did in the present case make amongst its shareholders a distribution of profits. It is well settled that the action of a Company in such matters not only binds its shareholders as between them and the Company, but determines as between them and the Revenue whether the result of the transaction is the receipt by the shareholders of taxable income as distinct from something which is not so taxable. The action of the Company then being the determining factor, it is necessary to consider whether the Company did or did not in the present case make a distribution of profits amongst its shareholders. The nature of what they in fact did is not in its details material in itself. The details of what they did are material in order to determine whether they made a distribution of profits or did something else. The position of things at the time the resolutions of the Company

(Warrington, L.J.)

were passed was this: there stood to the credit of the reserve fund in the books of the Company a sum of £357,500. That sum was not represented by any separate tangible assets or realisable assets, either in the shape of cash or in any other form. It was simply represented by the general assets of the Company and included in them. The result of what they did was this, and it happens to be exactly represented, I think, by the accountants' balance sheet. The form in which accountants express what has taken place does not always express the actual facts, but I think in this case it does, and if you look at the balance sheet of the 31st December, 1914, which was the first balance sheet prepared after the transaction had taken place, it is pretty clear that it does so. On that balance sheet you find amongst the liabilities £357,500 reserve fund. That is cancelled by the entry "Less bonus distributed, July 1914, in the form of debenture stock." Those two entries cancel each other, but in lieu of those there is inserted immediately after the statement as to the share capital of the Company this entry: "5 per cent. debenture stock: authorised—£500,000, issued—£357,500." You get, therefore, the same sum that was the liability of the Company before entered again as the liability of the Company, but in this special form, as a liability in respect of debenture stock. What is the effect of that? Prior to the transaction with which we have to deal the reserve fund simply constituted a part of the property of the Company. It was not separated in any way. It appeared as part of the property of the Company, and unless it had been inserted as a liability in the balance sheet it would have simply increased the balance of assets over liabilities. It remained, therefore, the property of the Company. The shareholders individually had no right to any part of it. It rested entirely with the Company whether they should retain that sum as it was or distribute it amongst the shareholders. What change has the actual transaction made in that state of things? It has made this change and, as it seems to me, this change alone, that the shareholders now, looking at it from their point of view, instead of having a right on winding-up or any such state of circumstances to receive as shareholders a share in the assets of the Company, become in respect of this £357,500 secured creditors individually each one for his share in that sum, for the amount of his debenture stock. Nothing is taken from the Company. The Company still have amongst their assets the whole of that £357,500, but they owe it to the individual shareholders so far as the debenture stock may be said to create a debt. It can be used for extension of the Company's business or for any other purpose to which the Company choose to apply it. The transaction amounts in my opinion in substance to an increase in the capital of the Company, using the word "capital" in its commercial sense and not in the more technical and limited sense in which you speak of the capital of a company governed by the Companies Acts, but for

(Warrington, L.J.)

commercial and practical purposes, the result of the transaction is, in my opinion, to increase the capital of the Company. If that be so, then there certainly is no distribution of profits among the shareholders. They had no option. Their bonus consisted, without any choice on their part, of the conversion of that indefinite interest which they had in all the assets of the Company to an individual interest in each case as a holder of a portion of this debenture stock. If I am right in what I have said it follows necessarily that this transaction did not amount to a distribution of profits.

So far I have said nothing about the authorities, and it is unnecessary to refer to any of them except the decision of the House of Lords in *Blott's case*⁽¹⁾. Of course, in *Blott's case*, as in so many cases which are referred to here as authorities on the case which one has to determine, the facts were not identical with the facts of the present case, but you must go behind the facts and see what was the principle which guided the tribunal in coming to the decision it did. I think the principle appears very clearly in the judgment of Lord Cave. I do not mean to say it does not appear clearly in the other judgments, but I happen to select as a clear statement of it the passage in the judgment of Lord Cave, where he says⁽²⁾: "Did 'this'—referring to the transaction in that case—" amount to "a distribution of profits? I think not. The resolution did "not give to any shareholder a right to sue for the dividend in "cash, his only right being to have an allotment of fully paid "shares in the capital of the Company." So here the resolution of the directors gives no right to any shareholder to sue for the amount of his bonus in cash; the only right which he had was to have an allotment of debenture stock. Then he goes on: "The profits remained in the hands of the Company as capital, "and the shareholder received a paper certificate as evidence of "his interest in the additional capital so set aside." So here the profits remained where they did in the hands of the Company as capital in the wider sense to which I have referred, and the shareholder received a paper certificate as evidence of his interest in the additional capital so set aside. Then Lord Cave goes on: "The transaction took nothing out of the Company's coffers, "and put nothing into the shareholders' pockets; and the only "result was that the Company, which before the resolution could "have distributed the profits by way of dividend or carried it "temporarily to reserve, came thenceforth under an obligation "to retain it permanently as capital." So here the Company retained this money, not perhaps permanently, but they retained this money upon the terms and conditions expressed in the debenture stock trust deed. In my opinion, in principle though not in detail, the decision in *Blott's case* covers the present case, and, therefore, the appeal must be allowed.

⁽¹⁾ 8 T.C. 101.

⁽²⁾ *Ibid.* at p. 135.

(Warrington, L.J.)

I have purposely omitted complicating what I had to say by reference to the transactions between the ordinary shareholders as entitled to debenture stock and the preference shareholders. I do not propose to discuss that at all. I only mention it to show that I have not forgotten it. In substance what the Company did to the ordinary shareholders was to provide for the allotment to them of debenture stock proportionate to the amount of their holding of ordinary shares, but by virtue of the rest of the transaction each shareholder, according to the amount of his holding, became, or in some cases might not become—as happened—bound to acquire preference shares with a part of that debenture holding. It makes no difference to the substance of the transaction. It is much simpler for the purposes of our decision to treat the transaction as it relates to debenture stock, and to that only. In my opinion, the appeal succeeds and, with all respect to Mr. Justice Rowlatt, the judgment was incorrect and must be set aside, and a decision given in favour of the taxpayer.

Scrutton, L.J.—As we are differing from the learned Judge below and as Mr. Hills has summarised his argument in a very confident assertion that if the House of Lords which decided *Blott's* case⁽¹⁾ against him had had these facts before them they would have decided in his favour, I, with due submission, express my judgment against him in my own words.

This Colliery Company had in 1913 a reserve fund of £293,035 and a balance to the credit of profit and loss of £167,279, and, to use its own language, it proposed to capitalise £357,500, being part of the undivided profits of the Company. The way it proposed to capitalise it was by issuing as a bonus to the owners of ordinary shares debenture stock to the extent of £357,500. That debenture stock would recognise a debt due from the Company to each owner of ordinary shares of a specific amount payable either at some future date when the Company made certain defaults, or suffered execution, or when the Company desired to redeem, or when the Company was wound up, but payable at a time with which the shareholder as such had nothing to do. He could not settle at all when it was payable, but he had debenture stock giving him a charge on the assets of the Company for that amount and carrying interest at the rate of 5 per cent. up to the time when the principal became payable. One further fact I should state. Carrying out that transaction, the late Bishop Fisher, who was a large ordinary shareholder in the Company, received £82,000 odd debenture stock. The Crown say that he must pay Super-tax on that debenture stock, which has not yet been precisely valued but which they take roughly at £80,000, as part of his income for the year, and I think it would follow, though it is not necessary to decide it in

⁽¹⁾ 8 T.C. 101.

(Scrutton, L.J.)

this case, that if Bishop Fisher were a tenant-for-life and there were remaindermen they would say that that debenture stock belonged to him as income and did not belong to the remaindermen. Now, as was said in *Bouch v. Sproule*⁽¹⁾ when that class of question was under discussion, you have to look at the substance of the whole transaction, and it was found in *Bouch v. Sproule* that the substance of the transaction was to convert the undivided profits into paid-up capital upon newly created shares, and, as it was a conversion into capital and not a payment of income, the bonus shares went in *Bouch v. Sproule* to the remaindermen and not to the tenant-for-life. Now looking here in the same way at what is the substance of this transaction, it seems to me that it is to convert undivided profits available at once for dividend, if the directors thought right, into capital assets of the Company with a specific charge on them in favour of each shareholder for a specific amount, not exercisable at the will of the shareholder, but only payable in future events depending on the Company. When one comes to the question whether what Bishop Fisher receives in that transaction is taxable for Super-tax, it appears to me that there are two questions which may be mixed up and which in *Blott's case*⁽²⁾, I think, are mixed up. First of all, does the subject receive anything at all? Secondly, if he does receive something, does he receive it as income or profits of property, or is it the property itself which he receives? An instance of the second class of case is *Burrell's case*⁽³⁾, where the Company was being wound up, and what the shareholder received, though it was once undivided profits of the Company, was in the winding up held to be the property being divided, and therefore not income and not assessable to Super-tax. Another case is where what the shareholder receives, though it was once undivided profits, is being paid in reduction of capital, and there he receives something, but he is receiving capital and not income. A third case, perhaps, is the case which I put in my judgment in *Blott's case*⁽²⁾ of the owner of a ship, whose ship is lost, and who receives insurance money for more than the original value of his ship but who receives it as capital, his property, and not as the income of his property. Those are cases where you do receive something but do not receive it as income. But the language in *Blott's case* of all the judges, I think, everywhere seems to waver between "You have not received anything at all," and "If you have received it you have received it as capital and not as income," and that may well be so, because what was received in *Blott's case*⁽²⁾ was certificates for shares, certificates showing that the recipient was entitled to certain shares in a Company or to certain capital of the Company. I think the stress of the argument for the Crown in this case has

(1) 12 A.C. 385.

(2) 8 T.C. 101.

(3) *The Commissioners of Inland Revenue v. Burrell*, 9 T.C. 27.

(Scrutton, L.J.)

been laid on the words "capital" and "capitalise," and they have said: How do you capitalise a thing by making a debt or issuing a security for a debt? By giving a man a security for a debt do you capitalise anything? You do not increase the capital of the Company by increasing the number of its creditors. It appears to me that entirely disregarding the word "capitalise," the Crown are in a great difficulty if they have to face the question what, here, did Bishop Fisher receive? He received nothing in the way of immediate cash, either capital or dividend, in the year of assessment. He received a recognition that the Company, if it had at the time property, would pay him something so many years hence, would secure that payment by a charge on its assets, whatever it happened to have (and it might at the time when the sum became payable have none), and would pay interest until the time when the debt became payable. Now when one looks at *Blott's* case, one finds the judgments full of statements which tend to show that the recipient in *Blott's* case received nothing, that it was not a question whether he received it as income—he received nothing. Lord Haldane at [1921] 2 A.C., page 184, says⁽¹⁾: "His new shares do not give him an immediate right to a larger amount of the existing assets. These remain where they were. The new shares simply confer a title to a larger proportion of the surplus assets, if and when a general distribution takes place as in a winding up. In these assets the undistributed profits now allocated to capital will be included, profits which will be used by the Company for its business but henceforth as part of its issued share capital." Lord Finlay at pages 194, 195 and 196 says the same thing⁽²⁾. "Instead of his getting any dividend, or anything in the nature of a dividend, the fund which might have been divided was impounded to increase the capital of the business. How is it possible to treat any advantage accruing from this as a payment of income?", and Lord Finlay quotes the learned Judge whom we are reversing in this case when in *Blott's* case he said: "'Now I do not think that there is a payment of a dividend to a shareholder unless a part of the profits of the company is thereby liberated to him in the sense that the company parts with it, and he takes it.'" I have been wondering whether when Mr. Justice Rowlatt gave judgment in this case he remembered what he had said in *Blott's* case, and how it was possible to say in this case that a part of the profits of the Company were liberated to Bishop Fisher in the sense that the Company parted with it and he took it. If Bishop Fisher had sold the debenture stock the Company would still have the debt to somebody. They would have parted with none of their assets. They would owe a debt *in futuro* to somebody, Bishop Fisher or somebody else.

(1) 8 T.C. at p. 126. (2) *Ibid.* at pp. 132 and 133.

(Scrutton, L.J.)

Lord Cave at page 200 says the same thing⁽¹⁾: "The resolution " did not give to any shareholder a right to sue for the dividend " in cash, his only right being to have an allotment of fully- " paid shares in the capital of the Company. The profits " remained in the hands of the Company as capital, and the " shareholder received a paper certificate as evidence of his " interest in the additional capital so set aside. The transaction " took nothing out of the Company's coffers, and put nothing " into the shareholders' pockets."

I have come to the conclusion that the real question in this case is, Did Bishop Fisher receive anything? and I cannot find, following the language of the noble Lords in *Blott's* case⁽¹⁾ that he did receive anything. What happened to the Company was that, whereas previously they had a reserve fund of undivided profits, that reserve fund to the extent of £357,500 disappeared from their balance sheet and remained as capital assets available, no doubt, for their creditors, charged in favour of Bishop Fisher in future events with repayment if it still then existed, but nothing was received by Bishop Fisher except the acknowledgment of a debt, and that appears to me, in view of the language used by all the noble Lords in *Blott's* case, not to be a receipt of anything by the shareholder in the year of assessment so that he could be taxed upon it. The case occurred to me which also occurred to my brother Warrington. If you give a creditor who has a debt payable five years hence a charge for his debt, does he receive the debt in the year when you give him the charge, and, if he does, what would happen in the year when he does receive the debt? Will you be able to say in that year, "Oh, it is quite true you have received £100 this year, but you " received it five years before, when you got a charge for it?" I should have thought the answer was obvious, that you do not receive it in the year when the debtor gives you a charge for it, but you do receive it in the year in which it is paid. I desire to avoid the word "capitalise," except in the sense that undivided profits have ceased to be undivided profits available for dividend and have become what are ordinarily called capital assets, and I propose to decide this case on the lines that nothing has been received by Bishop Fisher in the year of assessment. I think the mistake, with great respect to my brother Rowlatt, which he has made is in overlooking that consideration and in overlooking the test which he himself had applied when he gave his judgment in *Blott's* case.

For these reasons, which I have expressed in my own words, I think the learned judge came to a wrong conclusion and this assessment should be discharged.

Pollock, M.R.—There is no assessment, in fact. I see the Order of Mr. Justice Rowlatt was, sending it back for assessment.

⁽¹⁾ 8 T.C. at p. 135.

Mr. Latter.—Yes.

Pollock, M.R.—So that all you want is, appeal allowed with costs?

Mr. Latter.—If your Lordship pleases.

Warrington, L.J.—It would follow the words of the Notice of Appeal that the order and decision of the Commissioners be affirmed.

Mr. Latter.—If your Lordship pleases.

The Crown having appealed against the decision in the Court of Appeal, the case came on for hearing in the House of Lords before Viscount Cave, *L.C.*, and Lords Atkinson, Shaw of Dunfermline, Sumner and Carson on the 28th January and the 4th February, 1926, when judgment was reserved.

The Attorney-General (Sir Douglas Hogg, *K.C.*, *M.P.*) and Mr. R. P. Hills appeared as Counsel for the Crown, and Mr. Clauson, *K.C.*, Mr. A. M. Latter, *K.C.*, and Mr. Cyril King for the Executors.

On the 26th February, 1926, judgment was delivered unanimously against the Crown with costs, confirming the decision of the Court below.

JUDGMENT.

Viscount Cave, L.C.—My Lords, at the end of the year 1913 the Wearmouth Coal Company, Limited (which I will refer to as the Company) had an issued capital of £523,200, divided into five per cent. preference shares and ordinary shares. The books showed a reserve fund of £293,035 14s. 11d., and a balance to the credit of profit and loss account of £167,279 2s. 0d.; but these sums did not exist in cash or liquid assets, the reserve fund and a considerable part of the credit balance on profit and loss account having been expended in increasing the capital value of the Company's property. Early in the year 1914 the Directors were minded (as they expressed it) to "effect the capitalisation" of £357,500 of these funds by distributing that amount *pro rata* among the ordinary shareholders in the form of five per cent. debenture stock; but as the creation of a large debenture debt in front of the preference shares might be prejudicial to the holders of those shares, they proposed as part of their scheme that arrangements should be made by which the whole of the preference shares should be acquired by the ordinary shareholders in exchange for a corresponding amount of debenture stock.

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These proposals commended themselves to the shareholders of the Company, and the steps required for giving effect to them were duly taken. The Articles of Association of the Company were altered by special resolution so as to enable the Company in General Meeting to pass a resolution for capitalising the £357,500 and distributing that sum as a bonus among the holders of the ordinary shares in proportion to the amounts paid up on their shares, and so as to enable the Directors to issue debenture stock of the Company in satisfaction of the bonus. An agreement for the exchange of the preference shares for debenture stock was executed by representatives of the two classes of shareholders. A resolution for capitalising and distributing the £357,500 in accordance with the Articles as altered was passed by the Company in General Meeting and approved at a separate meeting of the preference shareholders; and five per cent. debenture stock to the amount of £357,500, secured by a trust deed, was created and issued in accordance with the scheme. The debenture stock trust deed provided that the stock should be a charge on the Company's undertaking and on all its property and assets for the time being, but should become enforceable only if the Company should make default in the payment of interest or in the performance of the covenants contained in the deed or in the event of a distress or execution or the appointment of a receiver or on the winding-up of the Company or a stoppage of its business; but by the conditions of issue the stock was made redeemable at any time after the 1st January, 1920, by six months' notice to be given by the Company. The result of these operations is reflected in the balance sheet of the Company for the year 1914, in which the reserve fund of £293,035 14s. 11d. and a sum of £64,464 5s. 1d. transferred from the profit and loss account are shown as cancelled by £357,500 "bonus distributed July, 1914, "in the form of debenture stock."

The late Bishop Fisher held 14,400 £5 ordinary shares and 7,640 £5 preference shares of the Company, all these shares being fully paid up except that upon 2,400 of the ordinary shares £2 10s. 0d. only was paid up. As the result of the transactions which I have shortly described, he became entitled, in July, 1914, to £82,500 of debenture stock of the Company, of which £16,540 had to be exchanged for preference shares of a like amount. He was not entitled to receive nor did he receive from the Company any payment in cash. He was assessed to Super-tax for the tax year 1915-16 on the above sum of £82,500 debenture stock as being income received during the preceding tax year; and, Bishop Fisher having died after the assessment, his executors (the present Respondents) appealed against the assessment to the Special Commissioners of Income Tax. Those Commissioners held that the bonus paid in debenture stock was not income in the hands of the recipient and was not a ground for assessment to Super-tax, and they accordingly discharged the

(Viscount Cave, L.C.)

assessment, subject to a Case which they stated for the opinion of the High Court. On the hearing of the Case Stated, Mr. Justice Rowlatt held that the bonus was income (though not necessarily income to the face value of the debenture stock) and was a ground for assessment to Super-tax, and he remitted the Case to the Commissioners to determine the amount of the assessment; but on appeal to the Court of Appeal that Court took the opposite view and restored the decision of the Commissioners. Hence the present appeal.

My Lords, it is impossible for your Lordships to determine the question under appeal except in relation to the previous decision of this House in the case of the *Commissioners of Inland Revenue v. Blott*⁽¹⁾, [1921] 2 A.C. 171. In that case a Company had capitalised a large sum of undistributed profit and had issued to its shareholders bonus shares to an equivalent amount; and it was decided by a majority of this House, after full argument, that the bonus shares were not income so as to found a claim for Super-tax. The only material distinction between that case and the present is that, while in *Blott's* case the bonus took the form of paid up preference shares, in the present case it was in the shape of debenture stock; and, unless that difference renders inapplicable the reasons for the decision in *Blott's* case, the conclusion in this case must be the same.

The *ratio decidendi* in *Blott's* case must, of course, be sought for in the speeches of the Lords whose opinions prevailed. Lord Haldane stated his views as follows⁽²⁾: " My Lords, for the reasons I have given I think that it is, as a matter of principle, within the power of an ordinary joint stock company with Articles such as those in the case before us to determine conclusively against the whole world whether it will withhold profits it has accumulated from distribution to its shareholders as income, and as an alternative not distribute them at all, but apply them in paying up the capital sums which shareholders electing to take up unissued shares would otherwise have to contribute. If this is done, the money so applied is capital and never becomes profits in the hands of the shareholder at all. What the latter gets is no doubt a valuable thing. But it is a thing in the nature of an extra share certificate in the Company. His new shares do not give him an immediate right to a larger amount of the existing assets. These remain where they were. The new shares simply confer a title to a larger proportion of the surplus assets, if and when a general distribution takes place, as in a winding-up. In these assets the undistributed profits now allocated to capital will be included, profits which will be used by the Company for its business but henceforth as part of its issued share capital. Such a transaction appears to me to be one purely of internal management, with which, for the reasons explained by Lord Davey in

⁽¹⁾ 8 T.C. 101.

⁽²⁾ *Ibid.* at p. 126.

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“ *Burland v. Earle* ([1902] A.C. 83, at p. 93), no Court can “ interfere.” And the noble and learned Lord relied strongly on the previous decision of this House in *Bouch v. Sproule*, (1887) 12 A.C. 385, where Lord Watson had said: “ In these circumstances it was undoubtedly within the power of the Company, “ by raising new capital to the required amount, to set free the “ sums thus spent out of the reserve fund and undivided profits “ for distribution among the shareholders. It was equally “ within the power of the Company to capitalise these sums by “ issuing new shares against them to its members in proportion “ to their several interests.”

Lord Finlay expressed his conclusion as follows⁽¹⁾:—“ The “ general scope and effect of these transactions is beyond dispute. “ There was an increase in the capital of the Company by the “ retention of the amounts available for dividends. . . . “ The use of the sums which had been available for dividend to “ increase capital would enable the Company to carry on a larger “ and more profitable business, which might be expected to yield “ larger dividends. These dividends, however, were to be in the “ future. So far as the present was concerned there was no “ dividend out of the accumulated profits; these were devoted to “ increasing the capital of the Company. The Company had “ power to do what it pleased with any profits which it might “ make. It might spend the accumulated profits in the improve- “ ment of the Company’s works and buildings and machinery. “ These improvements might lead to a great accession of business “ and increase of profits by which every shareholder would “ benefit, but of course it could not for a moment be contended “ that such a benefit would render him liable to Super-tax in “ respect of it. The benefit would not be in the nature of income, “ and Super-tax can be levied only on income.” And in a later part of his speech he said⁽²⁾:—“ The second contention of the “ Crown is that the allotment of the preference shares was “ equivalent to the payment of the bonus. To appreciate this “ point it is necessary to consider closely what it was that the “ shareholder got. Did he get anything in the nature of payment “ of income? It is obvious that he did not. He gave up any “ claim to the income. What might have been paid as income “ went to increase the capital of the Company. The shareholder “ got his proportionate share in the business of the Company as “ increased by the additional capital. The proportion of his “ share in that business as compared with the proportion of other “ shareholders was in no way affected by the issue of the “ preference shares, as all the shareholders alike got them. The “ benefit, and the sole benefit, which the Respondent derived “ was that the business in which he had a share was a larger one “ with more capital embarked in it, precisely as might have been “ the case if the accumulated profits had been applied in the

⁽¹⁾ 8 T.C. at p. 131.

⁽²⁾ *Ibid.* at p. 132.

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“improvement of the Company’s works and machinery. Instead of his getting any dividend, or anything in the nature of a dividend, the fund which might have been divided was impounded to increase the capital of the business. How is it possible to treat any advantage accruing from this as a payment of income? The case differs *toto cælo* from a case in which a dividend is paid not in money but in money’s worth by the delivery, say, of goods or of securities.”

The securities referred to in the sentence last quoted are of course securities forming part of the Company’s assets.

In a later case of *Pool v. Guardian Investment Trust Company*⁽¹⁾, [1922] 1 K.B., 347, where a Company had distributed not shares in its own stock but shares of another Company in which a part of its reserve was invested, Mr. Justice Sankey, in an interesting judgment, expressed the result of *Bouch v. Sproule*⁽²⁾ and *Blott’s case*⁽³⁾ as follows⁽⁴⁾:—“In my view the true test as to whether a distribution of shares falls to be taxed depends upon two questions: (1) whether there has been a release of assets; (2) if so, whether the assets released were capital or income;” and he held—and (I think) rightly held—that in that case there had been a release of assets as income upon which a claim for Super-tax could be based.

My Lords, if the tests which are to be found in these judgments are applied to the transactions now in question, I think that it will be found impossible to escape from the conclusion that the issue of debenture stock in the present case falls within the same category as the issue of shares in *Blott’s case*.⁽²⁾ Here, as in that case, the fund representing reserve and accumulated profits was at the disposal of the Company, which could determine as against the whole world whether that fund should be distributed to the shareholders as income or should be retained and applied to capital purposes. It is true that in this case the reserve could not (as the Articles stood) be distributed except under the authority of a special resolution, but such a resolution could have been passed. It is true also that all or the greater part of the fund had been expended in increasing the value of the Company’s property; but that difficulty could have been surmounted by borrowing an equivalent sum for distribution. The Company was, therefore, master of the situation, and it elected definitely and irrevocably not to distribute the fund as income, but to impound it and apply it as income-producing capital; and that election, if made (as I do not doubt that it was made) in good faith, was binding on the shareholders and could not be questioned by the Crown. No doubt, the shareholders got debenture stock which, like the shares in *Blott’s case*, was a valuable thing; but they had no power to call in the stock, which gave them no present right to receive any part of the

⁽¹⁾ 8 T.C. 167.

⁽²⁾ (1887) 12 A.C. 385.

⁽³⁾ 8 T.C. 101.

⁽⁴⁾ 8 T.C. at p. 178.

(Viscount Cave, L.C.)

Company's assets either in money or in money's worth, but only entitled them to a sum to be carved out of those assets if and when the stock was paid off. It is true that debenture stock, unlike shares, creates a debt; but the debt in this case was not presently payable and may never become payable while the Company is in existence. The whole transaction was "bare machinery" for capitalising profits and involved no release of assets either as income or as capital. Upon the whole, I think that this case is covered by the decision in *Blott's case*⁽¹⁾ and that in this case, as in that, the person sought to be charged had received no income upon which he could be charged with Super-tax in the succeeding year.

For these reasons I am of opinion that the appeal fails, and I move your Lordships that it be dismissed with costs.

Lord Atkinson.—My Lords, I concur.

Lord Shaw of Dunfermline.—My Lords, in view of the judgment just delivered by my noble and learned friend on the Woolsack, it is quite unnecessary for me to repeat at length the narrative of the facts of this case or to make again a citation of the provisions of the statutes relative thereto and the decisions of this House thereon.

Only a word is required to show how the question arises. In the year 1913, the Wearmouth Coal Company showed by their balance sheet that there was standing to the credit of profit and loss account, plus a reserve fund and a certain suspense account, a sum in all of £357,500. That the whole of it, or any portion, could have been, at the will of the Directors of the Company, distributed among the shareholders as dividends, there is, of course, no question; and, to the extent to which it was so distributed, it is undoubted that the dividend received would have been treated as income under the Income Tax Acts. The Directors of the Company and the shareholders were agreed, however, upon a different course of policy. The necessary steps were taken "to effect the capitalisation of £357,500 of these reserve funds by distributing this amount *pro rata* among the ordinary shareholders in the form of 5 per cent. debenture stock."

The Respondent in this appeal was a large shareholder. It was intimated to him that his "proportion of the bonus was £82,500 in respect of which" he was to "receive . . . debenture stock, amounting to £65,960 and 3,308 preference shares of £5 each, of the total nominal value of £16,540, together amounting to £82,500."

This £82,500, it is agreed by the parties, arose from the profits earned by the Company in which the Respondent was a shareholder. The effect of the transaction was without doubt to tie up this amount of profit which might have been given to the Respondent in cash—to tie it up in the hands of the Company

⁽¹⁾ 8 T.C. 101.

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either as preference shares or as debenture stock not realisable for a period of at least six years. The sum, therefore, which might have been paid in cash as income was devoted to capitalisation, and accordingly the sum was not only not paid away but was excluded from any income fund.

There are two views of this transaction. The first view on the side of its economics is that the nature of the transaction shows that it was to all intents and purposes equivalent to a distribution of dividend in cash by the Company and a receipt of income by the shareholder. It is agreed that, so far as figures are concerned, this is so. It is further manifest that by this system of finance—continued from year to year—it would be possible by the exercise of dexterity on the part of Company Directors and acquiescence on the part of shareholders, to add to each individual shareholder's capital interest in the Company so that in course of time such shareholder would find himself increasingly wealthy, the increments to his assets arising out of annual profit, and yet would be able to escape from the payment of that Super-tax which he would have contributed to the revenues of the nation had the distribution of the profits been made by the Company in cash.

This, according to the view presented, is contrary to the spirit of the Income Tax Acts, and is in defeat of the express prescription that the taxpayer shall state an account of his income received from all sources. Out of profits from year to year he has become wealthier from year to year. And so it is contended that the true meaning and intent of the Income Tax Acts is that this increment of wealth should be tapped for public uses.

The other view, and the one which in my humble judgment is sound, is, these things may, to speak generally, be very true, but they are not for the consideration of the Judiciary; they may demand or require the attention of the Executive and of the Legislature, but the task of the Judiciary is simply to comply not with the law as it ought to be but with the law as it is and it is that law alone which forms the prescription for the decision of the case here stated. In that prescription note must be taken of and loyalty given to the decisions of this House; otherwise, neither the Crown nor the subject would ever know where they were.

Further, even upon the side of figures, as stated, it is by no means clear that the idea of income or the employment of income applies to the facts of such a case as the present. The Company, before the operation of distribution of bonus per issue of debenture stock took place, stood in possession of so much capital, with so much accumulation and reserve. In a commercial and economic sense these accumulations of profit and reserve did add, and add largely, to the value of each share in the Company. When these were swept away, the value of each share subject to

(Lord Shaw of Dunfermline.)

ordinary market contingencies would be economically *pro tanto* reduced. That reduction of each shareholder's capital value as a market source was, however, recouped to him by the issue of debenture stock. He then stood in possession of a *pro rata* share of the capital stock of the Company which, added to his original shares though these were now reduced in value, left him at the end of the transaction as nearly as possible where he was in the matter of finance before the transaction began.

Upon the legal side of the matter it must not be forgotten that all the necessary resolutions, confirmations, new Articles of Association, etc., required to regularise the transaction have been carried through. It is a transaction in itself unassailable in law. The result of it was to negate emphatically the idea of distribution to shareholders as income; on the contrary, it was to withdraw from each shareholder the sum which might have been given to him as income and to withdraw it definitely from an income fund. It was stamped as a capitalisation transaction. Such a transaction was within the power of the shareholders of the Company, and all, including the Crown, are bound by that. It is incorrect in principle to attempt to get behind that transaction, legal and competent and regular in form, and to endeavour to construct a canon of liability to Income Tax out of conjecture as to the motive or scheme for the defeat of the Revenue which underlay its various stages. The money so capitalised could not pass to a tenant for life. If the Company were wound up, the whole would still be treated as its existing assets.

My Lords, I have thus stated the two views, in order in a single word to say that I think that this House is precluded by the authority of *Blott*⁽¹⁾, following the case of *Sproule*⁽²⁾, from adopting the view first expressed and is bound to follow that view which I have just sketched in the latter portion of my address.

It is needless to repeat again the emphatic declarations in both these cases which show the soundness of the various heads for consideration which I have just enumerated. I also conclude that the Crown fails in its attempt to make any distinction in principle between the facts of *Blott's* case and those of the present appeal.

The administrative or financial questions underlying your Lordships' decision are for consideration, as I have said, by the Executive and the Legislature, but cannot control the loyalty which we must pay to the text of the statutes and the judicial interpretations thereof.

Lord Sumner.—My Lords, the authority of *Blott's* case⁽¹⁾, [1921] 2 A.C. 171, constrains your Lordships to dismiss this appeal, but, as I regret the necessity for this conclusion, perhaps

⁽¹⁾ *Commissioners of Inland Revenue v. Blott*, 8 T.C. 101.

⁽²⁾ *Bouch v. Sproule*, 12 A.C. 385.

(Lord Sumner.)

I may venture to state how it is that, in my view, in spite of considerable differences of fact between the two cases, the result must, nevertheless, be the same.

Shortly stated, I understand that *Blott's* case was decided on this principle. To attract Super-tax to a bonus distributed to him by a Company, in which he is a shareholder, what reaches the taxpayer must at that moment bear the character of income, impressed upon it by the Company, which distributes it, and by it alone. Provided that the Company violates no statute and also keeps within its Articles, it can call the subject-matter of the distribution what it likes, and, I think, this involves the corollary, that it can either call it by a new name or simply discard its old one. After all, it is natural for the creature to be named by its creator. Further, what the Company says it is, that it is as against all the world. What the Company says it shall no longer be, that it is no longer for any purpose. How this is effected and by what resolutions, confirmations and instruments, does not matter, for such things are "bare machinery." In what the Company has said and done is found the answer to the question—What has the subject-matter of the distribution now become or ceased to be, when first it reaches the taxpayer? (See Viscount Haldane, pp. 182, 184, 188, and Viscount Finlay, pp. 194, 196, 197 of [1921] 2 A.C.⁽¹⁾.) Transmuted by this alchemy, profits in hard-earned gold become extra share certificates, and yet the shareholders, who receive them, may be greatly the gainers.

Both cases are alike in the following respects. In both the Company had among its assets considerable amounts of undivided profits and its Board proposed to distribute among its shareholders shares or stock of an aggregate face value corresponding to the amount of the undivided profits, which were to be dealt with. The Company passed a resolution to distribute a bonus in the form in the one case of preference shares, part of an authorised but as yet unissued amount, and in the other of debenture stock, newly created for the purpose. In the former case the shares were to be credited as fully paid and, as between the Company and the shareholders, the shares distributed carried no liability for calls but enjoyed a full right to participation upon the footing that they were paid up. In truth, however, nothing was paid up on the shares, though alterations in the books and balance sheet were made as required. In the latter case the Company executed a trust deed in which a large indebtedness was acknowledged to exist, which in truth was purely voluntary, for the Company had borrowed nothing and owed nothing to the trustees, and the deed included a covenant to pay off that indebtedness at a future time. To authorise

(¹) 8 T.C. at pp. 125, 126, 127, 132 and 133.

(Lord Sumner.)

the creation of this stock an amendment had to be made in Articles 42 and 43. Under the heading "Borrowing Powers," these were originally directed to borrowing money and to securing money borrowed. By this amendment they were extended to securing the payment of sums of money and securing the repayment by an issue of debenture stock. I assume, without deciding, that this amendment authorised what was done, since the Crown has not contested the point, though, even after the amendment, borrowing continues to be the salient and perhaps the pervading feature of the Articles. In neither case were any assets "released" (*Pool's case*⁽¹⁾, [1922] 1 K.B. 357); they remained in the business just as before. In each case the advantage, which the Company got by what was done, was simply this, that money, which might have been distributed at any time as dividend under ordinary resolutions declaring a dividend and authorising its payment, could no longer be dispersed in this simple way, but, if at all, only by more complicated resolutions duly passed by the shareholders and in *Blott's case*⁽²⁾ probably involving liquidation. Were there an antagonism in interest between a company and its shareholders, there might be some intrinsic advantage in such a change, but otherwise the object of it must in *Blott's case* be sought in some conflict of view between different bodies of shareholders as to the extent of the conservation of assets to be adopted by the Company, and in the present case also in some private liability affecting some of the shareholders but not the Company. As a matter of fact, if the sum, in respect of which the debenture stock was issued in this case, had been distributed as cash dividends, nearly the whole of the ordinary shareholders would have been chargeable with Super-tax in the following year and some of them in large amounts. To the Company this mattered nothing, but I cannot think it was lost sight of in the transactions in question.

In both cases the resolution with which the transaction began, spoke of "capitalising" the undivided profits and distributing the sum dealt with as a "bonus," and in both cases the use of the word "dividend" was carefully avoided. It was submitted to your Lordships, as the essence of the decision in *Blott's case*, that assets, consisting of profits earned but not divided, were to be turned into authorised share capital, and that, if so, the decision would not apply in the present case, where no alteration was made in the share capital. I am unable to accept the first reply suggested by the Respondents, that the sum actually was turned into capital, namely, loan capital, since it is clear that no such addition to effective capital, as arises when a Company borrows a large sum on the security of its assets, was brought

(1) *Pool v. The Guardian Investment Trust Co., Ltd.*, 8 T.C. 167.

(2) 8 T.C. 101.

(Lord Sumner.)

into existence at all, and I do not myself think that debts or promises to pay form part of capital, though some debtors do. The second reply was very different, namely, that it was natural to speak of "capitalising" and "converting" into capital in *Blott's* case, for there a purported "capitalisation" took place, but these expressions ought not to be read as limiting the *ratio decidendi* to cases where new paid up capital is created in the strict sense of the word. The real application of the principle is to assets, from which any further character of divisible profits has been taken away, whatever may be the substituted character thereafter impressed upon them. If so, that principle applies here. My Lords, for my part I think this argument is right and to hold otherwise would be disloyal to the former decision of your Lordships' House.

There are also expressions in *Bouch v. Sproule*⁽¹⁾ and in *Blott's* case⁽²⁾, which direct attention to the "substance" of the Company's transaction, but I do not think these affect the present appeal either. Lord Herschell (12 A.C. at p. 398) speaks of looking at "both the substance and the form"; so does Lord Finlay in *Blott's* case ([1921] 2 A.C. at p. 198⁽³⁾). Lord Cave, on the other hand, uses the expression ([1921] 2 A.C. at p. 201⁽⁴⁾) "if the substance and not the form of the transaction "is looked to . . ." In both cases, however, both the form and substance were fully considered. Not only were the deeds and resolutions construed but the scheme of the transaction, its financial results, and the supposed desires and intentions of the Company were examined. Lord Finlay speaks of the option, which was given to the shareholder in *Bouch v. Sproule*⁽¹⁾, as one which should be ignored because it was merely formal ([1921] 2 A.C. at p. 189⁽⁵⁾). Lord Cave speaks of that option, as at least so substantial that it might make a difference, and as a feature not occurring in *Blott's* case (p. 202⁽⁶⁾). In spite, however, of these discussions and divergences all the noble and learned Lords, who formed the majority, refused to be influenced by the fact that to call the shares "paid up" was formally untrue, on the ground that the form of transferring the required sum from the category of undivided profits to that of paid up share capital had been correctly gone through in accordance with the Articles.

Accordingly I think the present case cannot be distinguished on this ground. The proposition, that the substance of a transaction must be looked to and not merely the form, is generally invoked against those who have carried it out. I think it is unusual, where the form of a transaction is against those whose transaction it is, to invoke the substance in their favour, in order to eke out what they have

(1) 12 A.C. 385.

(2) 8 T.C. 101.

(3) *Ibid.* at p. 134.

(4) *Ibid.* at p. 135.

(5) *Ibid.* at p. 134.

(6) *Ibid.* at p. 136.

(Lord Sumner.)

left defective in form. Sometimes again it is the "intention" of the Company that is said to be dominant (*Burrell's case*⁽¹⁾, [1924] 2 K.B. at p. 68); sometimes it is what the Company "desired" to do ([1921] 2 A.C. at p. 200⁽²⁾). In any case desires and intentions are things of which a Company is incapable. These are the mental operations of its shareholders and officers. The only intention that the Company has is such as is expressed in or necessarily follows from its proceedings. It is hardly a paradox to say that the form of a Company's resolutions and instruments is their substance. At any rate, in the present case, there is no need to distinguish between form and substance in the transaction itself or to refer to desires or intentions, further than to examine what was done, for everything was carried out in plain terms and without concealment. What the requisite majorities of the shareholders desired and intended is pretty plain too, but that is another matter.

Equally must the Crown fail in its contention that the shareholder is taxable because at any rate the Company distributed money's worth, namely, debenture stock that could be sold. The point was before the House in *Blott's case*.⁽³⁾ Lord Haldane ([1921] 2 A.C. p. 184) said that the share distributed to the shareholder was "valuable" and Lord Finlay (p. 196) that it was "valueless," but this difference of opinion made no difference in their conclusion. Lord Cave (p. 199) expressly deals with it, saying that the shareholder no doubt got something which he could sell, but if he did so he would be selling a capital asset producing income (p. 200). The fact is that money's worth is not a material circumstance until the bonus distributed has been shown, when still in the Company's hands and at the time of distribution, to be impressed with the character of income of the Company. If it is not, the bonus does not attract tax as part of the Super-tax payer's income, even though he spends it, when he gets it, exactly as he spends his taxable income.

My Lords, the highest authorities have always recognised that the subject is entitled so to arrange his affairs as not to attract taxes imposed by the Crown, so far as he can do so within the law, and that he may legitimately claim the advantage of any express terms or of any omissions that he can find in his favour in taxing Acts. In so doing, he neither comes under liability nor incurs blame. It may be a question, however, whether these considerations of justice and public policy apply equally to a limited liability company, a creature of the law strictly controlled by statute, in a case where it has no interest in either payment of or escape from a tax that is not levied upon it. In this case, a sum of £64,464 5s., part of the profits of the current

(1) *Commissioners of Inland Revenue v. Burrell*, 9 T.C. 27, at p. 43.

(2) 8 T.C. at p. 135. (3) 8 T.C. 101, at pp. 126, 133 and 135.

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year 1914, has been dealt with apart from the undivided accumulations, an amount sufficient in itself to have paid a dividend on the issued ordinary shares of 25 per cent., or 5s. in the pound for every pound paid up, and by the use of "mere machinery" it has been converted into debenture stock, not redeemable under normal circumstances for six years certain. This is valid as against all the world, because *Bouch v. Sproule*⁽¹⁾ now applies to revenue cases and because, under *Blott's case*⁽²⁾, the mere decision of the Company, operating through voting majorities, whose private motives and interests may have been no concern of the Company at all, has this effect. If any part of the dividends of the year can be so converted, I presume all could be, nor, if a six years' currency of the debenture stock is permissible, do I see why six weeks should be less so. How far this position is tolerable is, however, a matter for the Legislature. It is not material here, but I think it may well be doubted whether, in the long run, it should be permissible for a limited liability company to create obligations, for which no consideration has been given to it, or to increase its paid up share capital out of its own assets, without imposing on the holders of this additional share capital the usual obligations, which are involved in the subscription of shares.

Lord Carson.—My Lords, I concur.

Questions put:

That the Order appealed from be reversed.

The Not Contents have it.

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

The Contents have it.

(1) 12 A.C. 385.

(2) 8 T.C. 101.