

COURT OF APPEAL—22ND, 23RD AND 24TH FEBRUARY, AND 17TH MARCH, 1955

HOUSE OF LORDS—23RD, 24TH, 25TH AND 26TH APRIL, AND 21ST JUNE, 1956

**Owen (H.M. Inspector of Taxes) v. Southern Railway
of Peru, Ltd.⁽¹⁾**

Income Tax, Schedule D—Leaving payments under foreign law—Basis on which payments deductible.

Under Peruvian law the Respondent Company was bound to pay its employees in Peru prescribed compensation payments upon the termination of their services with the Company, subject to the fulfilment by the employee of certain conditions. The amount to be paid depended on (a) length of service and (b) rate of pay at the end of the period of service, except that a reduction in pay would not affect the amount to which an employee was entitled by reference to the period of service already performed.

On appeal against assessments to Income Tax on the Company made under Case I of Schedule D for the years 1947–48 to 1951–52 inclusive, it was contended on behalf of the Company that upon proper principles of commercial accountancy amounts of compensation calculated to have accrued due to each employee from year to year as deferred remuneration should be allowed as a deduction. The Special Commissioners held that it was a matter of correct accountancy practice to make provision in the accounts for the sums in question, and allowed the appeal.

The Chancery Division held that the deferred payments must be brought into account for Income Tax purposes at the time when they became payable, and not before. The Court of Appeal affirmed this decision.

In the House of Lords (Earl Jowitt and Lords Oaksey, Radcliffe, Tucker and MacDermott) judgment was given in favour of the Crown. Earl Jowitt and Lords Radcliffe and Tucker were of opinion that, where a number of similar contingent obligations arise from trading, there is no rule of law which prevents the deduction of a provision for them in ascertaining annual profits if a sufficiently accurate estimate can be made; but that the provision claimed by the Company throughout the proceedings was not permissible by reason of the absence of discount and other factors. Lord Oaksey agreed with the judgments in the Court of Appeal.

Lord MacDermott, dissenting, favoured a remit to the Special Commissioners to ascertain whether it would be practicable to arrive at satisfactory deductions.

CASE

Stated under the Income Tax Act, 1952, Section 64, by the Commissioners for the Special Purposes of the Income Tax Acts for the opinion of the Chancery Division of the High Court of Justice.

At a meeting of the Commissioners for the Special Purposes of the Income Tax Acts held on 21st July, 1952, the Southern Railway of Peru, Ltd., hereinafter called "the Respondent", appealed against the following assess-

⁽¹⁾ Reported (H.L.) [1956] 3 W.L.R. 389; 100 S.J. 527; [1956] 2 All E.R. 728; 222 L.T.Jo. 10.

ments to Income Tax made upon it under Case I of Schedule D of the Income Tax Act, 1918 :

1947-48	...	...	£174,017	less	£26,544	capital allowances
1949-50	...	...	£232,879	less	£27,709	capital allowances
1950-51	...	...	£240,228	less	£62,116	capital allowances
1951-52	...	...	£185,930	less	£90,757	capital allowances.

The grounds of the appeal were that in computing the amounts of the said assessments no allowance had been made in respect of certain accrued liabilities which arose under Peruvian law hereinafter referred to and were properly deductible therefrom.

2. Evidence was given at the hearing of the appeal by Dr. Hernando De Lavallo, a qualified *abogado* of the Republic of Peru, sometime Dean of the Law Association of Peru and President of the Inter-American Bar Association and Vice-President of the International Lawyers Association, Honorary President of the Inter-American Bar Association and a director of a number of companies in Peru; Charles Maitland Duncan, a fellow of the Institute of Chartered Accountants in England and Wales and a partner in the firm of J. Dix Lewis, Caesar, Duncan & Co., chartered accountants, of Cannon Street, London, E.C.4, auditors to the Respondent (hereinafter referred to as "the auditors"); Reginald Longford Latimer, a fellow of the Institute of Chartered Accountants in England and Wales and a partner in the firm of Whinney, Smith & Whinney, chartered accountants, of London; William Henry Hall, an accountant employed by the Respondent; Rafael Francisco Jose Valls, a barrister-at-law and a member of the Spanish Bar, legal adviser to the Spanish Embassy, the Spanish Consulate General and the Spanish Chamber of Commerce; and the following documents were produced and admitted or proved :

- (1) A translation of Law No. 4916 of the Republic of Peru.
- (2) A translation by Dr. De Lavallo of Articles 294 and 296 of the Peruvian Commercial Code.
- (3) A translation of Law No. 5119 of the Republic of Peru.
- (4) A translation of Law No. 6871 of the Republic of Peru.
- (5) A translation of Law No. 8439 of the Republic of Peru.
- (6) A translation by Dr. De Lavallo of Law No. 9463 of the Republic of Peru.
- (7) A translation of Law No. 10211 of the Republic of Peru.
- (8) A translation of Law No. 10239 of the Republic of Peru.
- (9) A translation by Dr. De Lavallo of Article 2 of Law No. 7607 of the Republic of Peru.
- (10) A document showing the calculation of the compensation due in respect of two employees of the Respondent.
- (11) A copy of the memorandum and articles of association of the Respondent.
- (12) A bundle containing copies of the Respondent's accounts for the year to and balance sheet at 30th June, 1946, 1947, 1948, 1949, 1950, and 1951.
- (13) A translation by Dr. Valls of Articles 1107 and 1108 of the Civil Code of the Republic of Peru.

(14) A translation by Dr. Valls of Articles 293, 294, 295 and 296 of the Commercial Code of the Republic of Peru.

The above documents are not attached to and do not form part of this Case but are available for the use of the High Court if required.

3. On the evidence adduced at the hearing of the appeal, we found the following facts admitted or proved:

(1) At all material times, the Respondent, a company registered on 30th December, 1890, under the Companies Acts, 1862 to 1886, and having its registered office situate in England, operated a railway in the Republic of Peru which it controlled from the United Kingdom.

(2) The law of the Republic of Peru includes the undermentioned provisions (hereinafter referred to collectively as "the social legislation"), of which only Article 3 of Law 8439, Article 1 of Law 10211, and the Supreme Decree dated 14th April, 1944, apply to *obreros* or manual workers, and the remainder apply to *empleados* or clerical workers and administrative staff. All contracts of service must be deemed to import the social legislation in its entirety.

Peruvian Commercial Code

Article 293. If the contracts between the merchants and their clerks and salesmen are for a specified period, neither of the parties may withdraw without the consent of the other from the fulfilment thereof, until the completion of the agreed period. Those who contravene this enactment shall be liable in damages, save as is provided in the following Articles.

Article 294. The following are special causes enabling merchants to discharge their employees, even though the agreed period may not have expired:

1. Fraud or breach of trust in the matters confided to them.
2. The carrying out of commercial transactions for their own account, without the express consent or licence of the principal.
3. Serious lack of respect and consideration in regard to the principal or members of his family or dependants.

Article 295. The following grounds shall enable employees to take leave of their principals, even though the period of the contract has not been fulfilled:

1. Non-payment of salary or stipend at the agreed periods.
2. Non-fulfilment of any other condition agreed upon for the benefit of the employee.
3. Bad treatment or serious insult by the principal.

Article 296. In those cases where the engagement is not for a fixed period either of the parties may treat it as at an end by giving the other party one month's notice. In that event the clerk or salesman shall be entitled to the salary due for that month.

Law No. 4916 (modifying Article 296 of the Commercial Code).

The Congress of the Peruvian Republic has enacted the following law:

Article 1. Article 296 of the Code of Commerce is hereby modified as follows:

(a) If and when the engagement or lease of services is not subject to a fixed term of duration, evidenced by public deed, either party may terminate it provided that the employer gives ninety days prior notice to the employee or the employee notice of forty days to the employer.

(b) If and when termination of the engagement or lease of services should arise from a decision to such effect on the part of the employer, thereby giving notice of dismissal to his subordinate individual or employee, abiding by the procedure outlined in the foregoing subparagraph, the latter

shall be entitled to receive salary compensation following the scale set down below:

- Up to 2 years service time = One month's salary.
- From 2 to 5 years service time = Two months' salary.
- From 5 to 10 years service time = Four months' salary.
- From 10 to 20 years service time = Eight months' salary.
- From 20 to 25 years service time = Ten months' salary.
- From 25 to 30 years service time = Twelve months' salary.

(c) Such claims as may arise thereto will be resolved by arbitration tribunal whose members will be an arbitrator appointed by the employer, another appointed by the employee or employees involved in the claim, and the third member appointed by the Ministry of Fomento as a delegate of the Government, when in Lima, and outside Lima by the regional political authority; the award, which will be final, is to be issued within a maximum period of thirty days.

(d) In the event of controversy arising out of payment of the compensation referred to in subparagraph (b), the authority concerned may be able to assign provisionally, in accordance with the foregoing subparagraph, to the claiming employee an amount equivalent to two months' salary, by way of provisional alimentary pension, while awaiting settlement of the contention and provided that the demand is supported by written evidence or testimony from three persons considered fit in the tribunal's opinion.

The amount of the said pension will be deducted from the indemnity payment to be made to the employee concerned in accordance with subparagraph (b) of Article 1 of the present law.

Article 2. In such cases where dismissal of a subordinate individual or employee is due to any of the reasons contemplated in Article 294 of the Code of Commerce or any other serious offence which he may incur as per the opinion of the arbitration tribunal referred to in subparagraph (c) of Article 1, he will not be entitled to receive either the prior notice of dismissal or the indemnity payment or benefit of any kind.

Law No. 5119 (modifying Law No. 4916).

Article 2. Provided that an employee leaves his work or post giving forty days prior notice of his decision, as stipulated in Article 1 of Law No. 4916, he will still be entitled to enjoy the benefits provided for by the said law.

Only in the case of his leaving without prior notice and voluntarily will he lose the benefits provided for by the said law; notice of termination of services, either by the employer or the employee, must be given in writing in order to be considered valid.

Law No. 6871 (Rules for Procedure under Laws 4916 and 5119).

Article 1. Payment, such as the employer is required to make to his employee, in cases of dismissal provided for by Laws 4916 and 5119, will be calculated at the rate of half a month's salary (one-half of the monthly salary) for every year's service or fraction thereof, provided such fraction is not less than three months.

Article 2. Payment, such as is referred to in the foregoing Article, from the legal viewpoint, represents a remuneration which the employer pays for the work of his employee, whether the latter's engagement is for an indefinite period or for a fixed time, and whether or not registered as a public deed.

Article 3. An employee who works for account of a private individual, other than a permanent merchant, in enterprises or business concerns of a constant nature, is entitled, on leaving his post, to receive the remuneration established in Article 1 of this law, subject to the provisions contained in Laws 4916 and 5119 (1).

Article 4. The benefits and rights granted to employees in accordance with this law will rule after three months' consecutive service, which time will be considered as a trial period.

* * * *

Article 11. The rights accorded by this law are unrenounceable, any pact to the contrary will be rendered null and void.

* * * *

Article 14. All legal dispositions which are opposed to the present law are hereby derogated.

* * * *

Article 20. The half month's salary to which Article 1 refers will be computed on the amount of compensation actually received by the employee on the date of termination of his services. (Compensation here refers to rate of salary.)

Law No. 8439 (extending Law 4916).

Article 1. Business, agricultural and mining enterprises, credit institutions, insurance companies and all such concerns whose capital stock shall exceed the sum of five hundred thousand soles (Peruvian currency) are bound to pay their employees an indemnity in respect of service time, which compensation shall be calculated at the rate of one month's salary per yearly period, besides the salaries provided for by law, in the event of retirement or dismissal.

Article 2. In the event of the decease of an employee, the compensation which Law No. 4916 establishes, in respect of length of service time, along with amplifying and modifying provisions thereto, including the present law, shall belong to the heirs of the deceased, or, in these latter's default, to the person or persons who used to be his dependants economically.

Article 3. In these same enterprises, workmen shall have the right to receive an indemnity compensation equivalent to fifteen days pay per year's service, in the event of their dismissal. In the event of a workman's decease, the compensation shall pass along to his heirs or persons who depended economically on him.

Law No. 9463 (extending Laws 4916, 6871 and 8439).

A reduction in remuneration accepted by an employee shall not impair in any way the rights acquired for services rendered as granted under Laws Nos. 4916, 6871 and 8439, as compensation should be calculated per years of service in accordance with the remuneration received until the time of the reduction. Following compensation will be calculated in accordance with the reduced remuneration.

Law No. 10211.

Article 1. The workers retiring voluntarily from their work shall enjoy the indemnifying benefits granted by law, provided a notice given with an anticipation of 15 days is complied with, in the following cases:

(a) When services have been rendered during more than one year.

(b) When the worker is disabled to continue working on account of illness or incapacity. In case of the worker's death, indemnifications will pass on to his heirs.

Law No. 10239.

Sole Article. Article 1 of both Law No. 6871 and Law No. 8439 are hereby modified, in the sense that compensation which must be paid to business employees, in the event of retirement or dismissal, shall be calculated at the rate of one month's salary per yearly service time.

A Supreme Decree of the President of the Republic of Peru issued on 14th April, 1944, which after declaring that Law 4916 (which applies to *empleados* or clerical and administrative workers) applied by analogy in cases of services of workers and that where there is a change of employer by reason of the sale, transfer or amalgamation of a business, the legal compensation arising to employees and workers of the business who continue to be so employed after the sale, transfer or amalgamation, is the liability of the new employer, but that notwithstanding this legal provision it was nevertheless lawful for the vendor and purchaser of a business to make an agreement to the contrary,

provided that the compensation due to employers and workers was guaranteed, provides, *inter alia*, that in such a case where there is a sale, transfer or amalgamation of a business, the purchaser, transferee or person acquiring the business shall be freed from his legal liability in respect of such compensation provided that the vendor or assignor of the business deposits in the Caja de Depositos y Consignaciones to the order of the General Work Director on the day that the transfer is made, a sum equal to the total amount of the compensation computed and accepted as due by the interested parties.

(3) Law No. 7607 of the Republic of Peru (which deals with bankruptcy) provides as follows:

With the remaining movable and immovable property of the debtor, the following will be paid:—

- (i) The judicial costs arising from the Bankruptcy
- (ii) The judicial costs which the debtor owes for the defence of his property in the year prior to the declaration of Bankruptcy
- (iii) The salaries and wages corresponding to servants, staff and workers of the debtor, as also the compensation which may correspond to them in accordance with the respective laws.

(4) In computing the profits of the Respondent for the year to 30th June, 1946, no provision was made in respect of liabilities actual or contingent under the social legislation as the auditors, though aware of the general effect of the law, could not ascertain an exact figure, but the attention of shareholders was directed to the matter by the chairman of the Company. For the year to 30th June, 1947, and subsequent years provision was made in the balance sheet and a charge made in the revenue account. The charge was calculated in respect of each employee by reference to the number of years which each such employee had served and the then prevailing rates of pay. For example in the case of a clerical or administrative worker (*empleados*) whose rate of remuneration had not altered during the year the amount which the Respondent included in its charge in that year in respect of that worker was an amount equal to one month's salary at the then prevailing rate of pay. If the worker's salary increased during the year the amount included in the charge was an amount equal to one month's salary at the higher rate together with a sum equal to the amount of the increase in annual salary multiplied by the number of years of employment prior to that year. The sums ultimately payable by the Respondent in respect of any employee would be increased if the employee's rate of pay were subsequently increased, but would not be reduced if his rate of pay were subsequently reduced.

(5) The auditors would not have signed the balance sheet without a qualification unless the afore-mentioned provision had been made, because the making of such provision in the circumstances was the correct accountancy practice.

(6) No instance had yet occurred in which the Respondent had refused to pay an employee or workman the compensation provided for in the social legislation, either for the reasons stated in Article 294 of the Peruvian Commercial Code (hereinbefore referred to), or on any other ground.

(7) The Civil Code of the Republic of Peru contains the following provisions:

Article 1107—The fulfilment of the condition is indivisible even though it may consist of a service which is divisible. Where the condition has

been only partially fulfilled, the fulfilment of the obligation cannot be demanded, unless there be express agreement to the contrary.

Article 1108—The fulfilment of an obligation entered into subject to a suspensory condition cannot be enforced until the condition is complied with.

(8) The fiscal legislation of the Republic of Peru contains, *inter alia*, the following:—

(i) Article 8 of the Regulation on Tax upon Commercial and Industrial Profits which permits the establishment of reserves to cover the obligations derived from the social laws whenever these are sustained upon salary books which enable the computation of the length of service of each workman and their corresponding indemnities.

(ii) Article 19 of Law 7904 of the Income Tax which considers as expenses all sums paid for severance, indemnity and employees' insurance, in accordance with the pertinent laws, as well as the retirement and dependants' pensions paid by companies to their servants.

(iii) A Resolution dated 25th June, 1943, of the Superior Council of Contributions which expressly establishes that all reserves formed by the employers to cover employees' and workmen's indemnities are expenses exempt from the tax upon commercial and industrial profits.

4. It was contended on behalf of the Respondent :

(1) that upon the proper principles of commercial accountancy the amount of the compensation by way of deferred remuneration calculated to have accrued due to each employee of the Respondent at the end of every financial year under the provisions of the Peruvian social legislation and payable to any such employee upon his ceasing to be employed by the Respondent was a proper deduction in calculating the yearly amount of the Respondent's profits or gains ;

(2) that the said amount of compensation was equally a proper deduction in computing the amount of the profits or gains of the Respondent for the purposes of assessment under Case I of Schedule D, Income Tax Act, 1918, for each of the years in question ; and

(3) that the appeal should be allowed.

5. It was contended on behalf of the Appellant:

(1) that the liability of the Respondent for payments under the provisions of the Peruvian social legislation in respect of those employees and workmen who remained in its employment was contingent only ;

(2) that the only actual liability that arose by virtue of the said legislation in any year was in respect of actual payments to employees ;

(3) that, therefore, the only proper deduction in any year in respect of the Peruvian social legislation in arriving at the Respondent's profits for the purposes of United Kingdom Income Tax was in respect of actual payments made as aforesaid during that year ; and

(4) that the appeal should be dismissed.

6. We, the Commissioners who heard the appeal, found that whatever might be the correct legal description of the Respondent's obligation under the Peruvian social legislation with respect to the amounts of compensation calculated to have accrued due to the Respondent's employees at the end of each financial year, it was a matter of correct accountancy practice in England to make provision in the accounts for the sums in question in the circumstances of this case. This practice was endorsed by Peruvian fiscal law which permits the deductions in question in computing the Respondent's liability to Peruvian tax. We further found that the sums in question, being,

according to Peruvian law, deferred remuneration, there is nothing in Rule 3 of the General Rules applicable to Cases I and II of Schedule D, Income Tax Act, 1918, to prohibit the deduction of the sums in question in computing the profits or gains of the Respondent for the purposes of assessment to Income Tax under Case I of Schedule D for the years in question. We held accordingly that the sums in question formed a proper deduction in computing the Respondent's liability to Income Tax under Case I of Schedule D, Income Tax Act, 1918. We left the figures to be agreed between the parties on the basis of our decision in principle.

7. Later, on 20th October, 1952, the parties having agreed upon the figures, we adjusted the assessments as under:

- 1947-48. Assessment reduced to £48,736
less capital allowances £27,272
- 1949-50. Assessment reduced to £226,986
less capital allowances £28,622
Losses brought forward £126,890
- 1950-51. Assessment reduced to £222,742
less capital allowances £63,205
Losses brought forward £120,158
- 1951-52. Assessment increased to £253,739
less capital allowances £89,789
Losses brought forward £68,796.

8. The Appellant immediately after the communication to him of our final determination of the appeal declared to us his dissatisfaction therewith as being erroneous in point of law and in due course required us to state a Case for the opinion of the High Court pursuant to the Income Tax Act, 1952, Section 64, which Case we have stated and do sign accordingly.

9. The point of law for the opinion of the High Court is whether on the facts found by us there was evidence upon which we could properly arrive at our determination and whether on the facts so found our determination was correct in law.

Norman F. Rowe, } Commissioners for the Special Purposes
B. Todd-Jones, } of the Income Tax Acts.

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

30th July, 1953.

The case came before Upjohn, J., in the Chancery Division on 12th, 13th, 14th and 15th October, 1954, when judgment was given in favour of the Crown, with costs.

The Solicitor-General (Sir Reginald Manningham-Buller, Q.C.) and Sir Reginald Hills appeared as Counsel for the Crown, and Mr. John Pennycook, Q.C., and Mr. F. N. Bucher for the Company.

Upjohn, J.—This is an appeal by the Crown by way of Case Stated from a decision of the Commissioners for the Special Purposes of the Income Tax Acts, who have allowed the Respondent Company to deduct for the purposes of Income Tax from their profits certain sums alleged to represent deferred remuneration due to the Company's employees, which has not yet become payable but will almost certainly do so in the future.

The matter arises in this way. The Respondent Company, as its name implies, operates a railway in Peru and, of course, employs a very large number of persons. Under and by virtue of certain social legislation of the Republic of Peru, first introduced in the year 1924, the Respondent Company is bound to pay compensation to each of its employees in Peru upon the termination of his or her services with the Company, provided certain conditions are fulfilled. This legislation provides that it is deemed to be imported into all contracts of service and no employer can in any way contract out of its provisions.

I must now read the relevant provisions of the law of Peru, which I think are fully set out in the Case Stated. I will start with a number of Articles in the Peruvian Commercial Code, and in particular Articles 293 to 296 inclusive. Article 293 is in these terms:

"If the contracts between the merchants and their clerks and salesmen are for a specified period, neither of the parties may withdraw without the consent of the other from the fulfilment thereof, until the completion of the agreed period. Those who contravene this enactment shall be liable in damages, save as is provided in the following Articles."

Article 294:

"The following are special causes enabling merchants to discharge their employees, even though the agreed period may not have expired: 1. Fraud or breach of trust in the matters confided to them. 2. The carrying out of commercial transactions for their own account, without the express consent or licence of the principal. 3. Serious lack of respect and consideration in regard to the principal or members of his family or dependants."

Article 295:

"The following grounds shall enable employees to take leave of their principals, even though the period of the contract has not been fulfilled: 1. Non-payment of salary or stipend at the agreed periods. 2. Non-fulfilment of any other condition agreed upon for the benefit of the employee. 3. Bad treatment or serious insult by the principal."

Article 296:

"In those cases where the engagement is not for a fixed period either of the parties may treat it as at an end by giving the other party one month's notice. In that event the clerk or salesman shall be entitled to the salary due for that month."

Now I come to the legislation which created this right to compensation on ceasing employment. The first is Law 4916, which I am informed was passed in the year 1924. Article 1 says this:

"Article 296 of the Code of Commerce is hereby modified as follows: (a) If and when the engagement or lease of services is not subject to a fixed term of duration, evidenced by public deed, either party may terminate it provided that the employer gives ninety days prior notice to the employee or the employee notice of forty days to the employer. (b)"

—this is the important one—

"If and when termination of the engagement or lease of services should arise from a decision to such effect on the part of the employer, thereby giving notice of dismissal to his subordinate individual or employee, abiding by the procedure outlined in the foregoing subparagraph, the latter shall be entitled to receive salary compensation following the scale set down below."

(Upjohn, J.)

That scale has subsequently been modified, and therefore I shall not read it. I do not think I need read anything more from that Article. Article 2 is in these terms :

"In such cases where dismissal of a subordinate individual or employee is due to any of the reasons contemplated in Article 294 of the Code of Commerce or any other serious offence which he may incur as per the opinion of the arbitration tribunal referred to in subparagraph (c) of Article 1, he will not be entitled to receive either the prior notice of dismissal or the indemnity payment or benefit of any kind."

That law was modified by Law No. 5119, and Article 2 provides this :

"Provided that an employee leaves his work or post giving forty days prior notice of his decision, as stipulated in Article 1 of Law No. 4916, he will still be entitled to enjoy the benefits provided for by the said law."

Under the earlier law the employee only received benefits if his employer dismissed him. That gives him the right to the benefits if he leaves his employer provided he gives due notice, for the law continues :

"Only in the case of his leaving without prior notice and voluntarily will he lose the benefits provided for by the said law; notice of termination of services, either by the employer or the employee, must be given in writing in order to be considered valid."

So that to enjoy this compensation he must give notice in writing of forty days.

The next law is Law No. 6871, which altered the scale. Article 1 says this :

"Payment, such as the employer is required to make to his employee, in cases of dismissal provided for by Laws 4916 and 5119, will be calculated at the rate of half a month's salary (one-half of the monthly salary) for every year's service or fraction thereof, provided such fraction is not less than three months."

Article 2 is important and is much relied upon :

"Payment, such as is referred to in the foregoing Article, from the legal viewpoint, represents a remuneration which the employer pays for the work of his employee, whether the latter's engagement is for an indefinite period or for a fixed time, and whether or not registered as a public deed."

Then Law No. 8439 increased in certain cases the indemnity, as they call it there, to a scale of one month's salary per year's service. Article 2 provides for the first time what was to happen upon the death of the employee during his employment. It is in these terms :

"In the event of the decease of an employee, the compensation which Law No. 4916 establishes, in respect of length of service time, along with amplifying and modifying provisions there'to, including the present law, shall belong to the heirs of the deceased; or, in these latter's default, to the person or persons who used to be his dependants economically."

Then the next Law, 9463, deals with the case where the employee's remuneration may be reduced, and says this :

"A reduction in remuneration accepted by an employee shall not impair in any way the rights acquired for services rendered as granted under Laws Nos. 4916, 6871 and 8439, as compensation should be calculated per years of service in accordance with the remuneration received until the time of the reduction. Following"

—I think that should really be "Subsequent"—

"compensation will be calculated in accordance with the reduced remuneration."

That Article is obscure, but fortunately the parties are agreed as to its operation in practice.

(Upjohn, J.)

Then Law No. 10211 deals with workers, that is, wage earners, whereas, as I understand it, the earlier Law No. 4916 had only applied to the salaried workers, or, as I may call them, black-coated workers. Article 1 provides this:

"The workers retiring voluntarily from their work shall enjoy the indemnifying benefits granted by law, provided a notice given with an anticipation of 15 days is complied with, in the following cases: (a) When services have been rendered during more than one year. (b) When the worker is disabled to continue working on account of illness or incapacity."

So that gave the worker the right to his compensation on giving fifteen days' notice.

Then Law No. 10239 increased the scale for another class of workers also to one month's salary for a year's service.

Then there was a Decree of the President of the Republic of Peru

"which after declaring that Law 4916 (which applies to *empleados* or clerical and administrative workers) applied by analogy in cases of services of workers . . ."

I do not think I need read any further the provisions of the law of Peru. Upon the face of them these provisions seem somewhat complicated, but in fact there is no dispute as to their operation, and it will be easiest to illustrate their operation by reference to one or two examples.

In the case of an employee engaged for an indefinite period, upon being dismissed by the employer, except for some reason set out in Article 294 of the Commercial Code, he becomes entitled to one month's salary for every year of service, the relevant salary being that earned in the last year of his employment, assuming it to be the highest salary he has received. Thus, an employee being dismissed after twenty years' service, his last year's salary being assumed to be £1,200 per annum, would be entitled to £100 multiplied by twenty, that is, £2,000. Also he would be entitled to that sum on his voluntary retirement from service, provided he gives the appropriate notice of forty days or fifteen days as the case may be. Likewise, if the employee dies in the service of the Company, his heirs would be entitled to a like sum.

Presumably, although the laws are not very explicit on the point, an employee engaged on the terms of a fixed contract will be entitled to compensation on the expiry of the fixed period calculated by multiplying his last year's salary (assuming it to be the highest) by his years of service. Presumably, too, if he becomes entitled to leave before the expiry of the fixed period for one of the reasons set out in Article 295 of the Commercial Code, he will receive compensation based on his actual number of years' service and his last year's salary earned during his last year of actual employment.

Where the salary of an employee has been constant throughout his employment, or, though fluctuating, his last year's salary is not less than his salary at any period of employment, the compensation is calculated by reference to the last year's salary, and his earlier salary is irrelevant. Where there have been downward variations operating at the time of dismissal, the matter is a little more complicated, but an example will illustrate the agreed operation of the law. Let us suppose an employee received £600 per annum for the first five years, £1,200 per annum for the next five years, and £600 per annum for the last five years, and then he is dismissed. His compensation will be for the first ten years one month of his highest salary, i.e. £100, multiplied by ten years, and for the last five years £50 multiplied by five years, making a total of £1,250.

(Upjohn, J.)

Now, what the Company claim to do is this. They say, and say truly, that provided the employee is not dismissed pursuant to Article 294, and provided he gives the necessary number of days' notice before retiring voluntarily, it is possible in every year to state with complete accuracy the minimum sum which on death or other termination of his employment he or his heirs will become entitled to, namely, one-twelfth of that year's salary. A subsequent drop in the salary cannot affect that figure, though it may well be increased if the salary is subsequently increased. That minimum sum may be regarded as deferred remuneration for that year, and therefore ought to be allowed as a deduction for Income Tax purposes in computing that year's profits.

To take an example, an employee is employed for five years at £600 per annum, and then for five years at £1,200 per annum. In each of the first five years, so it is said, the employee ought to be credited in the books of the Company with £50, that is, one month's salary. In the sixth year, owing to the increase in salary, he ought to be credited with £350, that is to say, £100 for year 6 and five years' increment at £50 per year, making a total of £350. In the subsequent four years he is credited with £100 in each year, for that is the minimum he could get. He may well get more, perhaps a great deal more, if his salary is subsequently increased, but he cannot get less. That is said to be the effect of the law, and that is the question I have to determine.

The respective contentions are these. The Solicitor-General says that, although it is true in a loose sense to say that on engaging an employee you at once become liable to make a payment upon retirement, it is quite wrong to speak of it as a liability for Income Tax purposes until it has become an obligation to pay, that is, upon death or retirement. The law provides, he says, not for a deferred payment based on salary year by year (although he does not concede that even that would entitle the Company to succeed), but the only obligation imposed upon the Company is to make a payment upon retirement, a payment calculated by reference in nearly every case to the last year's salary. He points out, naturally, too, that you cannot calculate the sum attributable to any given year, but only a minimum sum, and he also relies on the fact that the right to the payment is contingent in that the employee may so act that the sum may never become payable.

It is true to say, however, that he rests his main argument on the broad principle that for Income Tax purposes this liability ought not to be treated as a liability until it has become a liability or obligation enforceable by the employee. In no reported case, the Solicitor-General said, has the subject been allowed to deduct a wholly future and contingent liability except in the insurance cases, where different considerations applied from the very nature of a policy of assurance, and he referred me to a number of cases which he said supported his submissions.

Mr. Pennycuik, for the Respondent Company, put his case in this way. He said with perfect accuracy that, although the right to payment was strictly contingent, this contingency was negative in that failure of the right to receive payment depends solely on some act or omission of the employee; once an employee was engaged, nothing that the Company did or omitted to do could affect the employee's right to demand payment on cesser of his employment. Then he pointed out with equal truth that there was no inducement to any honest employee to forfeit his right to compensation, and that, as stated in paragraph 3 (6) of the Case, the Company had never in fact refused to pay compensation. He submitted that the true effect of the

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social legislation deemed to be incorporated in every contract of service is this, that at the end of each year the Company became under a firm liability to pay to the employee a certain minimum sum in respect of the services of the employee rendered during that year, the time of payment being the termination of the employee's employment. He stressed, and rightly, the fact that it was entirely outside the power of the Company to do anything to defeat the employee's right to those minimum payments, and further he pointed out that in respect of that minimum sum the employee was under no obligation whatever to render any further services in respect thereof. In brief, it was said that at the conclusion of any given year the employee became in respect of that year's service entitled to a minimum sum measured by one-twelfth of his salary for that year, and, of course, a further irreducible sum if his salary had been increased during that year, and that nothing that happened subsequently, except dismissal under Article 294 or failure to give due notice on voluntary retirement, could possibly affect his right to that minimum sum.

Thus, said Mr. Pennycuik, when properly interpreted, the social legislation provided for a method of deferred remuneration (and indeed Law 6871 expressly so states), and it was a system of deferred remuneration for services not generally over the whole period of employment, but provided a yardstick for measuring the minimum due in respect of each year's service separately.

If that be right, the argument proceeded, it would be right, before striking the true balance of the Company's gains in any year, to deduct the whole of the remuneration, whether payable immediately or in the future, which by the law of Peru it is necessary to expend in order to pay for those services in each year which are required to carry out the Company's operations, and so earn an income in that year. Mr. Pennycuik referred me to a number of authorities upon the analogous case where a company is entitled to bring in deferred payments for goods, or *per contra* is bound to bring in subsequent *ex gratia* payments for services rendered, as in the *Woolcombers' case*(¹), which he said supported his submissions.

I hope I have done proper justice to the respective contentions of the parties.

Now, the question I have to consider is this: in computing the full balance of profits and gains for the year, as provided by the Rule applicable to Case I of Schedule D, ought these deductions to be allowed? We are not concerned with any question of statutory allowances or prohibited deductions, and the question is one which essentially depends on its own circumstances.

The law was succinctly stated by Lord Haldane, L.C., in *Sun Insurance Office v. Clark*, 6 T.C. 59. The passage is to be found at page 78, when Lord Haldane said this:

"It is plain that the question of what is or is not profit or gain must primarily be one of fact and of fact to be ascertained by the tests applied in ordinary business. Questions of law can only arise when (as was not the case here) some express statutory direction applies and excludes ordinary commercial practice, or where, by reason of its being impracticable to ascertain the facts sufficiently, some presumption has to be invoked to fill the gap."

When the argument concluded yesterday, I reserved judgment, as I desired to consider whether, out of deference to the careful arguments I have heard on both sides, some detailed reference to the numerous authorities

(¹) *Isaac Holden & Sons, Ltd. v. Commissioners of Inland Revenue*, 12 T.C. 768.

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that had been cited to me ought to be made in this judgment; but I have come to the conclusion that it is unnecessary and therefore undesirable, for the circumstances of this case are unusual and its solution must depend entirely on its own special and particular facts.

The Respondents' argument depends upon establishing two major, though closely related, propositions: first, that upon its true interpretation the social legislation does provide for deferred payments for each year's service a certain minimum sum; and, secondly, that it is right to regard that minimum sum as a proper obligation for Income Tax purposes of the year in which the services are rendered, although payment is deferred until the contract of service is determined.

In my judgment the Respondents fail to establish either of these two propositions.

With regard to the first one, there is nothing whatever in the legislation that I can see which leads one to the conclusion that the Legislature was intending to provide for deferred remuneration calculated by a certain minimum sum for each year, referable exclusively to the services rendered in that year. On the contrary, it seems to me perfectly plain that the Legislature was intending to provide that upon cesser of employment an ex-employee should be entitled to a benefit generally on account of his services, and in fixing the scale had in mind no particular services in any particular year. Had it been otherwise the scale of compensation must have been related to the salary of each year of service.

The matter may be illustrated by reference to the example I have given of an employee receiving £600 a year for five years followed by £1,200 a year for five years. If the Respondents' contention be correct, the deferred remuneration for the first five years is £50 per annum, for the sixth year £350, and for the following four years £100 per annum, and that is indeed a nonsensical result. Reference to document 10, which gives real figures, illustrates the point equally well. It is, of course, essential to the Respondent Company that they should be able to attribute this deferred remuneration to a particular year of service, for they cannot possibly claim to bring in against their balance of profits or gains a sum which is generally on account of services already rendered and to be rendered in the future, and therefore, as they fail, in my judgment, on that point, that is fatal to their case.

With regard to the second point, it seems to me to be abundantly clear that the only obligation in any true legal sense arises in the words of the basic statute, 4916:

"If and when termination of the engagement or lease of services should arise . . ."

It is perfectly true that in practice when a man is engaged it is heavy odds on that on his cesser of employment, perhaps many years later, the obligation to pay him deferred compensation will arise, and it may be that an employee at the end of each year's service will say to himself: Well, there is another nest egg of a certain minimum sum which I know will become due to me when I retire.

That, however, does not determine the matter. I have to consider this matter in accordance with ordinary commercial principles, and the ordinary rule is that the proper time to debit a liability of the Company is when it has become a present liability, or more truly an obligation; that is to say, in an ordinary case, has become payable. That is the ordinary rule, and

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though in some cases that rule must bend to other considerations, such, for example, where there is a deferred payment for goods which have been delivered and so brought in on the balance of profits, I see nothing to displace the rule here.

With all respect to Mr. Pennycuick's ingenious and subtle argument, the legislation simply does not bear the interpretation that something ought to be regarded as accruing year by year for the benefit of the workers. The liability, in my judgment, plainly arises for the first time, at any rate for Income Tax purposes, when the employment ceases, and it is at that time that the sum becomes ascertained. He therefore fails on this point also.

I have not so far referred to the findings or decision of the Special Commissioners. The only evidence of commercial practice before them, so far as appears from the Stated Case, was that the auditors refused to sign the balance sheet without qualification unless provision for the deferred payments was made. No one criticises the auditors for that, and indeed I do not doubt that it was a very proper attitude to take; but it does not bear upon the question whether these sums are a proper deduction for the purposes of Income Tax. As has been pointed out in the authorities, it may be very proper to make a deduction or provision before considering what ought to be divided up by way of dividend, but that is very different from considering what ought to be deducted for tax purposes. It follows that the Commissioners had no evidence before them upon the question of commercial practice, but, of course, they were entitled to express their own views upon it. Before expressing their own views, however, to which normally I should attach the greatest possible weight, it would seem essential in a case of this sort to come to a clear conclusion as to the true interpretation of the legislative terms imported into each contract of employment, a task which, as I read paragraph 6 of the Case Stated, they declined. When you are dealing with Peruvian legislation, you can surely only express a view as to the correct relevant accountancy practice in England when you have evaluated the rights and liabilities of the parties in comparable English terms, and as the Special Commissioners have failed to do that I differ from them with less reluctance.

The result is that in my judgment these deferred payments must be brought into account for Income Tax purposes at the time when they become payable upon the death or retirement of any given employee, and not before, and accordingly the appeal must be allowed.

Do I have to send it back, or is that automatic, Sir Reginald?

Sir Reginald Hills.—Yes, my Lord, it should be sent back to adjust the assessments in accordance with the judgment.

Upjohn, J.—Yes; and, Mr. Pennycuick, I suppose you will have to pay the costs.

Mr. John Pennycuick.—I could not resist that.

The Company having appealed against the above decision, the case came before the Court of Appeal (Sir Raymond Evershed, M.R., and Jenkins and Romer, L.J.J.) on 22nd, 23rd and 24th February, 1955, when judgment was reserved. On 17th March, 1955, judgment was given in favour of the Crown, with costs.

Mr. John Pennycuik, Q.C., and Mr. F. N. Bucher appeared as Counsel for the Company, and Mr. C. Montgomery White, Q.C., and Sir Reginald Hills for the Crown.

Sir Raymond Evershed, M.R.—In this case I have had the advantage of seeing the advance judgments prepared by my brothers. I do not think I can usefully add anything to those judgments, with which I find myself in full accord.

Jenkins, L.J.—The question in this case is whether the Appellant Company in ascertaining the yearly amount of the profits of its trade or business for the purposes of United Kingdom Income Tax is entitled to deduct from the gross profit of each year sums prospectively payable under Peruvian law to its employees as compensation on the termination of their employment. The Special Commissioners have held that the Company is entitled to make this deduction. Upjohn, J., has held that it is not so entitled. The Company now asks us to reverse the decision of Upjohn, J., and restore that of the Special Commissioners.

The Company, as its name implies, operates a railway in Peru and it employs in this undertaking a large number of persons. The compensation in respect of which the Company claims to make the disputed deduction is payable under Peruvian legislation, referred to in the Case Stated as "the social legislation". The Special Commissioners, in the course of the Case Stated, have set out at length translations of such parts of the laws of Peru as were cited to them as relevant to the question: and Upjohn, J., has also referred to many of these provisions in the course of his judgment. Unfortunately the Special Commissioners, although they had the assistance of a witness learned in Peruvian law, did not, at any rate in terms, express as a conclusion of fact what was the law of Peru as it affected the question which they had to decide, apart from a finding to the effect that the compensation was according to Peruvian law deferred remuneration. It is, however, clearly open to this Court in the circumstances to form its own view of the effect of the Peruvian law by considering the proper meaning of the translated passages of that law (see *De Béeche v. South American Stores, Ltd.*, [1935] A.C. 148) and it did not appear that there was any real conflict between the parties thereon. It may, however, be convenient if I give a brief summary of the relevant laws and then state what I conceive to be the essential conclusions upon them.

The so-called social legislation of Peru begins with four Articles (293-296 inclusive) of the Commercial Code. The first three of these Articles are concerned with contracts with "clerks and salesmen" employed under agreements for fixed terms and contain a prohibition against determining such contracts before they have expired according to their tenor, with certain exceptions in favour both of master and servant. Thus, for example, the master may determine in case of dishonesty on the part of the servant and the servant may determine in case of non-payment by the master of salary or other breach by the master of conditions of the contract. For present purposes Article 296 is the most significant and forms the foundation for the later development of the so-called social legislation. It provides that in the case of contracts other than for stated terms, either party may determine them by giving one month's notice to the other.

Next comes the first amendment to Article 296 by Law 4916 which, according to the learned Judge, was promulgated in 1924. By Law 4916:—
(a) the period of notice of determination was altered—on the employer's

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side 90 days' notice was made requisite but 40 days' in the case of the employee; and (b) in cases of termination by the employer the employee was to receive compensation calculated at a month's, or so many months', salary for so many years of service.

The next modification of the basic provision was by Law 5119. This law enabled the employee to obtain compensation benefits as above in the alternative case under Law 4916 of his terminating the contract of service by the requisite 40 days' notice.

The third amendment was by Law 6871 expressed to constitute "rules of procedure" under Laws 4916 and 5119. The material modifications of the previous law were:—(a) the scale for compensation in case of termination of the service contract by the employer was altered in manner not now material; (b) the compensation payments were declared to represent

"remuneration which the employer pays for the work of his employee" whether the service was under a fixed term contract or otherwise; and (c) the provisions as to termination of contracts, compensation, etc., above were expressed to be "unrenounceable", i.e., were applicable in all cases between master and servant, anything in the contract of service to the contrary notwithstanding.

Fourth, Law 8439 extended the above provisions to all types of businesses (subject to certain irrelevant exceptions) and fixed the scale of compensation at that now prevailing, viz., one month's salary for every year of service

"in the event of retirement or dismissal".

The law also provided that the benefit of the compensation rights would pass to the representatives of a deceased employee.

Fifth, Law 9463 further modified the previous laws by providing that a reduction in remuneration of an employee should

"not impair in any way the rights acquired for services rendered".

The effect of this law arithmetically is stated hereafter and will be found to be of considerable significance in the solution of the problem now before the Court.

Finally, the President of the Republic by a Decree of April, 1944, declared that the Law 4916 as subsequently amended and extended should apply generally to all classes of workers.

From the above summary the short effect, so far as relevant, of this legislation appears to be as follows—and, as I have already said, I do not think there is any real dispute upon it between the parties:—

1. In the event of, that is, upon the determination of any service contract between the Company and any employee, whether from the employee's death, expiry of the term, or notice of determination given on either side, the Company is liable to pay compensation calculated as later appears to the employee or his representatives.

2. The above general proposition is subject to exceptions:—(a) in the case of fixed term contracts where the contract has been determined by the employee before expiry of the term otherwise than on account of infringement by the Company; and (b) in the case (apparently) of all contracts of service where there has been wrongful conduct of certain kinds by the employee, e.g., dishonesty or insubordination.

3. The right to this compensation is regarded as part of the remuneration for the services rendered by the employee.

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4. Although the right to receive compensation is strictly conditional upon due performance by the employee of the terms of service up to the moment of determination thereof, in practice (so it is said in evidence) no case has so far ever occurred in which the Company has withheld payment of the compensation to any ex-employee or his representative.

5. The compensation is an amount equivalent to one month's salary or one-twelfth of a year's salary at the rate in force at the date of determination for every year of service, provided that the right to compensation accrued up to any point of time is not liable to be diminished in amount by subsequent reduction in pay. This proposition, which had considerable significance in argument, may be illustrated thus: AB is employed for five years at £600 per annum, for the next five years at £720 per annum and for the last five years at £480 per annum: on retirement AB does not get merely £40 multiplied by 15, but £40 multiplied by 5 plus £60 multiplied by 10—the effect of the increase in salary in year six being enjoyed equally in respect of the first five years' service as of the second.

6. Finally, by reason of the express provisions as to notice, etc., although the compensation is expressed to be payable only in the event of, that is, upon, the final conclusion of the service, a man employed otherwise than for a fixed term may always at the end of any year, by giving 40 days' notice (and subject to performing his contract until expiry of notice) obtain payment of all compensation accrued up to the end of that year.

The contentions advanced for the Company may be thus summarised:—
(i) The result of the social legislation is to give each employee as and when he completes each year of his service a vested right to receive on the termination of his service the sum which that year's service has added to the compensation prospectively payable to him; (ii) that the Company incurs year by year a corresponding obligation to each employee to pay him on the termination of his service the sum thus accruing, which may be increased by any subsequent increase in his remuneration but can never be reduced; (iii) that the sum thus accruing to each employee on completion of each year's service is in the nature of additional remuneration which, albeit deferred as regards time of payment until the termination of his service, forms part of the consideration payable to him for the services he has rendered during that year; (iv) that apart from cases of employment under fixed term contracts, which are rare, every employee can at any time give the statutory 40 days' notice and claim on its expiration immediate payment of the compensation accrued to him; and (v) that in these circumstances each year's addition to the compensation prospectively payable to each employee continuing in the service is just as much part of the yearly cost of operating the Company's undertaking as are the sums actually paid out each year in wages or salaries, or the sums actually paid out in compensation to employees leaving the service during each year.

Consistently with these contentions the Company in respect of the years of assessment 1947-48 and 1949-50 to 1951-52 inclusive have adopted the following method of accounting. There is debited to the year's revenue account a sum equal to the aggregate amount of the year's additions to the total amount of compensation accrued in respect of all employees. From this sum there is deducted the total amount of compensation which became actually due and payable to employees leaving the service during the year, and the balance is carried to an account on the liabilities side of

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the balance sheet designated "Current Liabilities", where it is included under the heading "Sundry Creditors and accrued expenses". The Company claims that the balance so dealt with, although remaining in the Company's hands and represented by assets which continue to be employed in its business, is, in accordance with the contentions summarised above, properly deductible as an expense in computing the true yearly profit of the Company for Income Tax purposes. Evidence was given before the Special Commissioners by a member of the firm of chartered accountants who are the Company's auditors and by two other accountants, and on the accountancy aspect of the case the Special Commissioners found (Case Stated, paragraph 3 (5)) that

"The auditors would not have signed the balance sheet without a qualification unless the afore-mentioned provision had been made, because the making of such provision in the circumstances was the correct accountancy practice."

They reverted to this finding in stating their conclusions in paragraph 6 of the Case where they said:

"We, the Commissioners who heard the appeal, found that whatever might be the correct legal description of the Respondent's obligation under the Peruvian social legislation with respect to the amounts of compensation calculated to have accrued due to the Respondent's employees at the end of each financial year, it was a matter of correct accountancy practice in England to make provision in the accounts for the sums in question in the circumstances of this case. This practice was endorsed by Peruvian fiscal law which permits the deductions in question in computing the Respondent's liability to Peruvian tax. We further found that the sums in question being, according to Peruvian law, deferred remuneration, there is nothing in Rule 3 of the General Rules applicable to Cases I and II of Schedule D, Income Tax Act, 1918, to prohibit the deduction of the sums in question in computing the profits or gains of the Respondent for the purposes of assessment to Income Tax under Case I of Schedule D for the years in question. We held accordingly that the sums in question formed a proper deduction in computing the Respondent's liability to Income Tax under Case I of Schedule D, Income Tax Act, 1918. We left the figures to be agreed between the parties on the basis of our decision in principle."

Mr. Pennycuik, for the Company, urged that the conclusions thus expressed by the Special Commissioners should not have been disturbed by the learned Judge. He said that questions as to the sums proper to be included or (in the absence of statutory prohibition) deducted in arriving at the full amount of the profits and gains chargeable to tax under Case I of Schedule D should be decided in accordance with ordinary business principles, or in other words in accordance with the ordinary practice of commercial accountancy; that it was for the Special Commissioners to find on the evidence whether the method of accounting adopted in the present case conformed to those principles or not; and that the Commissioners having found that this method did conform to those principles their decision, though not conclusive, should be accorded great weight, and should only be rejected if the Court is clearly of opinion that the Company's method of accounting fails to reflect the true profit for Income Tax purposes. For the proposition that questions of this kind are to be decided in accordance with ordinary business principles, or in other words the ordinary practice of commercial accountancy, Mr. Pennycuik referred us to the well-known case of *Sun Insurance Office v. Clark*, 6 T.C. 59, where the House of Lords, distinguishing *The General Accident Fire and Life Assurance Corporation v. McGowan*⁽¹⁾, held that a yearly reserve made by an insurance company of 40 per cent. of its premium income to cover

(1) 5 T.C. 308.

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unexpired risks was a proper deduction from its profits for Income Tax purposes. Lord Loreburn, L.C., at page 75⁽¹⁾, said:

"An estimate being necessary and the arriving at it by in some way using averages being a natural and probably inevitable expedient, the law, as it seems to me, cannot lay down any one way of doing this. It is a question of fact and of figures whether what is proposed in each case is fair both to the Crown and to the subject."

Lord Haldane, at page 78, said:

"It is plain that the question of what is or is not profit or gain must primarily be one of fact and of fact to be ascertained by the tests applied in ordinary business. Questions of law can only arise when (as was not the case here) some express statutory direction applies and excludes ordinary commercial practice, or where, by reason of its being impracticable to ascertain the facts sufficiently, some presumption has to be invoked to fill the gap."

Lord Alverstone, at page 80, said:

"The question of what are profits or gains within the meaning of the Income Tax Act is *prima facie* a question of fact, and if the cases from *The Imperial Life Insurance Company v. Wilson*⁽²⁾ (35 L.T. 271) in the year 1876, down to *The General Accident Insurance Company v. McGowan* in the year 1908 be examined, it will be found that in every case the Courts have treated the question as one of fact and have merely decided whether upon the facts before them the claim of the taxpayer to make a deduction in a particular way was justified."

On this authority Mr. Pennycuik at the outset of his argument was disposed to put his case so high as to say that where a particular way of arriving at the yearly profits or gains of a given trade or business is found by the Commissioners on evidence to be in accordance with the ordinary practice of commercial accounting, the Court should uphold the Commissioners' decision if satisfied that the way in question is in accordance with the ordinary practice of commercial accounting, which means, I suppose, if satisfied that there was evidence on which the Commissioners could so find. There might, said Mr. Pennycuik, be more than one way of arriving at the profits, but if a particular way propounded by the taxpayer was shown to be in accordance with ordinary commercial practice it should not be rejected in favour of some other possible way. This argument, which would make the Commissioners' finding virtually conclusive, and which moreover draws no distinction between profits for Income Tax purposes and profits which prudent methods of accounting would show as free or available profits, was not persisted in by Mr. Pennycuik, who later felt himself obliged to admit that the Commissioners' finding to the effect that the provision here made was in accordance with correct accountancy practice was not conclusive of the question whether it was a proper deduction to make in arriving at the true profit for Income Tax purposes. This admission is well warranted by the authorities. We were referred to the decision of this Court in *Patrick v. Broadstone Mills, Ltd.*⁽³⁾, [1954] 1 All E.R. 163, where a cotton spinning company had adopted a system of accounting known as the "base stock system", which was objected to by the Crown as failing to show the true profit of the company for Income Tax purposes. The Commissioners found

"that the method adopted by the Company in dealing with its base stock in its accounts was one of the methods recognised in this particular trade of cotton spinning and was in accordance with sound commercial practice."

Nevertheless, this Court, affirming Vaisey, J., rejected the base stock system in favour of the method of accounting contended for by the Crown. At the

(¹) 6 T.C. (²) 1 T.C. 71 (*sub nom.* Imperial Fire Insurance Co. v. Wilson). (³) 35 T.C. 44.

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end of his judgment Singleton, L.J., cited with approval the following passage from the judgment of Vaisey, J.⁽¹⁾:

"On the whole, I have come to the conclusion that my decision in this case must be for the Crown. I am satisfied that the base stock method of accountancy as adopted by the company is recognised and accepted in the industry and is unobjectionable for some commercial purposes. But I hold that it is not appropriate for the purpose of assessments to income tax, because it does not afford a true picture of the profits in any one year of charge, and because for that purpose the process stock of the company at the beginning and end of a year of charge should be valued and brought into account at cost (being lower than market value). It seems to me that in computing the company's profits no part of such stock should be either treated as a fixed asset or brought into account as a mere arbitrary figure."

We were also referred to the following passages from the speeches of Lords Porter and Radcliffe in *Ryan v. Asia Mill, Ltd.*, 32 T.C. 275. Lord Porter, at page 296, said:

"Nor do I think that any guidance can be obtained from the Revenue accountant's evidence. The arrangement was a peculiar and exceptional one and no general accountancy practice can be called in aid. Moreover what may be prudent accountancy for a company is not necessarily the correct method of ascertaining the proper assessment for Income Tax."

Lord Radcliffe, at page 301, said:—

"Mr. Gower gave evidence that in his opinion what they did was correct 'from an accountancy point of view'. That is an opinion entitled to respect but it cannot take over from the Commissioners their duty of deciding the case. It is not as if it were evidence that by a settled principle of commercial accounting or the established general practice of accountants payments such as these arising under an agreement such as this are treated as part of the cost of stock-in-trade. If there were such evidence, uncontradicted, it might well have been the Commissioners' duty to act on it, for if the law guides itself by the principle of accountancy as to cost or market price, whichever be the lower, it must I think guide itself also by any of its principles which determine how cost is made up. But Mr. Gower's evidence did not, and, I should suppose, could not, amount to anything like this: could not, because these payments depended upon the special provisions of a special agreement and are of a nature, accordingly, that could hardly fall under any general rule or within any general category. I think therefore that the Commissioners were quite right in thinking that what they had to do was to find out what the effect of the agreement was and then to come to their own decision upon the matter."

In *Peter Merchant, Ltd. v. Stedeford*, 30 T.C. 496, Tucker, L.J. (as he then was) said, at page 508:

"Mr. Grant, in his concise and attractive argument on behalf of the caterers, put his case quite shortly, as follows. He said: Unless it can be shown that this deduction is expressly prohibited by Rule 3 of the Rules applicable in Cases I and II of Schedule D, the question merely is—is this a deduction which can properly be made from an ordinary business standpoint? He says: I have called a witness who says it is; that is a question of fact; that evidence has been accepted by the Commissioners and that ends the matter",

and at page 509:

"In the first instance I draw attention to the very wide language used in the evidence of the accountant, as set out in the Case. It is that 'In his opinion the accounts had been prepared in accordance with the principles of sound commercial accounting; and if he had been the auditor to the Appellant Company, he would not have been prepared to certify the accounts as correct if the provisions to meet the Appellant Company's liabilities in respect of equipment shortages had not been made year by year in the manner in which the accounts showed them to have been made'. The first part of that statement, that the accounts had been prepared in accordance with the principles of

(1) [1954] 1 All E.R. 163, at p. 175; 35 T.C. 44, at p. 68.

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sound commercial accounting, would, I think, not be sufficient to carry Mr. Grant, because they might well have been prepared in accordance with the principles of sound commercial accounting without being permissible deductions before arriving at the profits in a particular year. His case is somewhat strengthened by the evidence of the accountant approving the manner in which the accounts had been made up."

It is clear from these cases that the Commissioners' finding to the effect that it was a matter of correct accountancy practice to make provision in the Company's accounts for the compensation prospectively payable does not conclude the matter. The finding is no doubt entitled to respect, and I do not say that so far as it goes it should not be accepted. But as Lord Porter said in *Ryan v. Asia Mill, Ltd.*⁽¹⁾,

"what may be prudent accountancy for a company is not necessarily the correct method of ascertaining the proper assessment for Income Tax";

and the question still remains whether the provision made by the Company for compensation prospectively payable, even though made in accordance with correct accountancy practice, is a deduction which the Company is entitled to make in arriving at a true estimate of the amount of its yearly profits for Income Tax purposes.

Mr. Pennycuick contended that this question should be answered in the affirmative, on the general principle that where a trader incurs in a given year a debt for goods sold to him or for services rendered to him in that year the debt so incurred is for Income Tax purposes an outgoing of that year, even though the debt does not become actually payable until a subsequent year, or is payable by instalments over a period extending beyond the year; while conversely where a trader becomes entitled in a given year to payment for goods sold and delivered, or for services rendered and completed by him during that year, the payment is for Income Tax purposes income of that year even though it does not become actually payable until a subsequent year, or is payable by instalments over a period extending beyond the year.

We were referred to a number of authorities bearing upon this principle, which is indeed well settled. See, for example, the well-known case of *Isaac Holden & Sons, Ltd. v. Commissioners of Inland Revenue*, 12 T.C. 768, where in a given year woolcombers did work for the Government on a commission basis, and after the end of the year the rate of commission was, as a result of negotiations, increased, and it was held that the additional commission having been wholly earned by the work done in the year in question was income of that year, although not paid until a later date, and although the company had in fact no right to demand any such increase. See also *Commissioners of Inland Revenue v. Newcastle Breweries, Ltd.*, 12 T.C. 927, where *Isaac Holden & Sons, Ltd. v. Commissioners of Inland Revenue* was approved in the House of Lords in a case raising a comparable question as to an addition to the price payable for rum compulsorily acquired which had been made after the year in which the compulsory acquisition took place. Mr. Pennycuick puts the present case as being in effect the converse of *Isaac Holden & Sons, Ltd. v. Commissioners of Inland Revenue*, the position here, according to his argument, being that the addition accruing each year to the compensation prospectively payable to any employee is remuneration which he earns, and to which he completes his title, by the services which he renders during the year, and conversely is

(1) 32 T.C. 275, at p. 296.

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part of the cost incurred by the Company in that year of the services rendered by the employee in that year and exclusively attributable to the services so rendered.

If Mr. Pennycuick's premises were justified by the facts in regard to the nature of the Company's obligation under the Peruvian social legislation, I would be inclined to accept his conclusion, though even then there would be difficulty in allowing the full amount of the yearly provision sought to be deducted; for in those cases in which sums prospectively payable or receivable can properly be treated as outgoings or receipts of the year in which the liability for them is incurred it is not, generally speaking, proper to allow the full amount of the future payment at its face value, at all events where the sum carries no interest, the proper deduction being as a rule an amount representing the present value (i.e., the value at the time the deduction is made) of the sum prospectively payable. See as to sums receivable *Absalom v. Talbot*⁽¹⁾, [1944] A.C. 204, per Lord Simon at page 212, Lord Atkin at page 215, Lord Russell of Killowen at page 221; and, as to sums payable, the judgment of Bray, J., in *Sun Insurance Office v. Clark*⁽²⁾, at page 62, where he said:

"You have received your goods and you must set against them the price that you are going to pay; and the fact that that price has not been paid during the year does not prevent it being deducted. You must deduct the value of the liability to pay that price whenever it occurs."

The result of treating the full amount of each year's increment in the aggregate amount of compensation prospectively payable as an expense deductible in ascertaining the profits of the Company for that year is to make the cost to the Company of each year's increment in the year in which it accrues the same as it would have been if all the employees of the Company had left its service at the end of such year in circumstances not disentitling them to compensation. That is clearly wrong, for, quite apart from the question of disqualification, to which I will presently return, it is obvious that much of the increment allowed for in full must be in respect of compensation prospectively payable to employees who in fact remain in the Company's service, and consequently do not become entitled to draw their compensation, for many years. Mr. Pennycuick says this merely goes to quantum and that if the deduction is right in principle there would be no insuperable difficulty in arriving at an actuarially calculated adjustment in the amount of the deduction. There is no evidence as to the possibility of calculating any such adjustment, or what it would come to if made, as the matter in issue has throughout been whether any deduction should be made at all, and not what the amount of the deduction should be if any deduction at all is allowable. Nevertheless it does appear that if any deduction at all is allowable it cannot be right to deduct the full amount, and I find difficulty in seeing how any calculation of an appropriate lesser amount could be much more than a guess. This element of uncertainty seems to me in itself to raise a doubt whether it can be right in principle to make the deduction at all. However that may be, it is clear that even if the deduction is right in principle the amount sought to be deducted is too large.

The principle on which Mr. Pennycuick relies as justifying the deduction is, I think, only applicable as far as liabilities are concerned where both the following conditions are satisfied, viz. :—(i) the liability must be certain, not contingent (see *Ford v. Commissioners of Inland Revenue*, 12 T.C. 997,

(¹) 26 T.C. 166.

(²) 6 T.C. 58.

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Peter Merchant, Ltd. v. Stedeford, 30 T.C. 496, and *Spencer v. Commissioners of Inland Revenue*, 32 T.C. 111); and (ii) the benefit in respect of which the liability is incurred must be exclusively referable to the year in which it is sought to debit the liability as an expense, or in other words where, as in the present case, the benefit consists of services, the liability must be an obligation incurred in that year exclusively in respect of services rendered during that year: this, I think, appears from the speeches of Lords Porter and Reid in *Albion Rovers F.C. v. Commissioners of Inland Revenue*, 33 T.C. 331. Lord Porter, at page 340, said:

"It may be that, if the Club was under the necessity to make and did make one single payment in order that they might obtain the services of their players and if that payment was to be attributed to services rendered in respect of the year of charge only, it could successfully be contended that the payment must be deducted as expenditure for earning income in that particular year. No doubt if a merchant obtains delivery of goods for which he is under no obligation to pay until a date following the year of charge, it cannot be maintained that the goods which he has purchased enhance his profits by increasing the value of his stock-in-trade without taking account of the liability incurred, although as a matter of commercial practice it may be that in some cases the income and expenditure is treated in a running account in which, as a matter of convenience, the value of the goods received is set off against payments made in the year of receipt for other articles. But the accurate course is to set off against the enhanced value of stock the price incurred in its purchase even though that price is payable at a later date. No such considerations, however, either on the one side or the other, come into the present question. There is no finding of commercial practice, the Commissioners have found against the Respondents and your Lordships' decision must be governed by the facts which they have found. In particular there is no finding that the expenses were incurred for the one year only or that the training required, and other obligations imposed on players for the months of May, June, July, 1949, were solely attributable to the earnings of profits in the year of charge."

Lord Reid, at page 342, said:

"Counsel for the Respondents first sought to justify this method of computation by arguing that a taxpayer is entitled, in computing his profit in any year, to deduct from his receipts all sums for which he has had to assume liability in order to earn those receipts, although such sums do not become payable until after the end of the year. So stated the proposition is clearly too wide because the purpose or effect of assuming such liability may be partly to earn profits during the current year and partly to earn profits in a subsequent year. That was the position in the present case. According to the Respondents the wages paid in May, June and July, 1948 and 1949, were spent in order to earn profits during the intervening period of nine months, only eight of which were within the financial year in question. So the Respondents do not seek to deduct the whole of the sum for which they undertook liability in the year in question, but only an appropriate proportion of those sums. Therefore, the argument must be that, where liability is assumed for expenditure beyond the current year, that expenditure must be allocated and attributed to the current year in so far as its purpose or effect can be shown to have been the earning of revenue during the current year. I think that there are at least two answers to that argument. In the first place, it would generally be laborious and often impracticable to make such an allocation. It may be that in the present case an allocation is practicable, but the right to relate back an allocated part of subsequent expenditure can hardly depend on the relative ease or difficulty in making a proper allocation. And, secondly, if this method were proper where the earning of the receipts precedes the payment of the cost of earning them, it is hard to see why it should not also be proper where the expenditure is made in an earlier year than that in which the resultant profit is made. But that was the case in *Vallambrosa Rubber Company, Ltd. v. Farmer*, 1910 S.C. 519; 5 T.C. 529. There the company had incurred expense in tending young rubber trees which would not become productive for several years.

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It was argued that this expense was not a proper deduction in the year in which it was incurred because it could not produce or help to produce revenue during that year. But this argument was rejected and the deduction was allowed. I think that the reasoning in Lord Dunedin's opinion is unanswerable and, so far as I am aware, it has never been questioned."

In my judgment the deduction here claimed fails to satisfy either of these conditions.

As to the first condition, Mr. Pennycuick said that cases in which employees left the service of the Company in circumstances disentitling them to compensation under the social legislation must obviously be of rare occurrence, and that in any case the practice of the Company was to pay in all cases, whether the employee was strictly entitled to claim compensation or not. He relied on the finding of the Special Commissioners in paragraph 3 (6) of the Case Stated that:

"No instance had yet occurred in which the Respondent had refused to pay an employee or workman the compensation provided for in the social legislation, either for the reasons stated in Article 294 of the Peruvian Commercial Code (hereinbefore referred to), or on any other ground."

Therefore, said Mr. Pennycuick, it was a practical certainty that compensation would in fact be paid in all cases, and this was enough for the present purpose. I cannot agree. Generous as are the terms of the social legislation towards employees, they do disqualify an employee from claiming compensation in certain events. The Company's liability in respect of compensation to any employee for the time being in its service is therefore a contingent liability and continues to be such until the employee's right to compensation is made absolute by the termination of his services in circumstances not disentitling him to compensation. The Company's practice of paying compensation in all cases is irrelevant. If the Company chooses as an act of grace to pay compensation in a case in which it is not legally bound to do so, it may well be that the payment is deductible in the year in which it is made as an expense dictated by considerations of policy. But it by no means follows that on the strength of this practice the Company can properly treat its contingent liability for compensation prospectively payable as an absolute liability in order to justify debiting it as an expense in any year earlier than the year in which it actually becomes payable. I should add that I do not think Mr. Pennycuick's argument derives any real assistance from the contingent character of the liabilities for which provision was made and allowed in the *Sun Insurance* case⁽¹⁾, as that case turned on the special considerations applicable to insurance business and the proper method of estimating the profit arising in each year from a business of that description.

As to the second of the above-mentioned conditions, it is no doubt true that by the express terms of the social legislation the compensation represents "a remuneration which the employer pays for the work of his employee". But does it follow that each year's increment in the compensation prospectively payable to any employee is remuneration payable to him exclusively in respect of the services rendered by him in that year? In my view it does not; and I think that conclusion is demonstrated by the case of an employee whose salary is increased, for example an employee who after serving for five years at £240 per annum has his salary increased in the sixth year to £480 per annum. In this example the employee upon his salary being increased would become prospectively entitled to compensation at the rate one-twelfth of his increased salary multiplied by six (that is, £40 × 6 = £240) in lieu of the £20 × 6 = £120 to which he would have

(¹) 6 T.C. 59.

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been prospectively entitled apart from such increase, and the sixth year's increment in his prospective compensation would be £140 made up of £40 for that year plus an additional £20 for each of the five previous years. I fail to see how it could sensibly be said that this increment of £140 represented, and represented exclusively, remuneration for services rendered by him in the sixth year. Mr. Pennycuick sought to meet this difficulty by saying in effect that the accounts for the first five years might be re-opened and £100 of the £140 debited to those five years at the rate of £20 per annum, so as to produce a flat increment of £40 per annum for each of the six years. But that is as much as to admit that the actual yearly increment which the Company claims to deduct in each year is not wholly or exclusively an expense of that year, and if it is not, then the claim to deduct it as an expense of that year must fail. Moreover, the difficulties in the way of attributing increments to services rendered in particular years would not be removed by any re-opening of accounts even if an unlimited right to re-open accounts could be claimed by the Company. There might, for example, be an employee who entered the service as a booking clerk at £240 per annum who rose in twenty years to be a manager at £2,400 per annum. His compensation would be calculated at the rate of £200 for each of his twenty years of service, equals £4,000. But I do not see how it could sensibly be said that he earned £200 of this £4,000 by the services which he rendered to the Company during each of his twenty years of service. These considerations lead me to the conclusion that the compensation payable to an employee on leaving the service of the Company is, as Mr. Montgomery White for the Crown has contended, payable in respect of his services as a whole and not as an aggregate of yearly increments each of which represents exclusively remuneration for services rendered by the employee during the particular year in which it accrues.

Reverting to the evidence accepted by the Special Commissioners to the effect that the making of the provision in question was in the circumstances the correct accountancy practice, and that the auditors would not otherwise have signed the balance sheet without a qualification, I cannot regard it as establishing anything more than that the Company's liability for compensation prospectively payable was a liability for which provision ought to be made as a matter of correct and prudent accountancy, or as deciding the question, which it was for the Commissioners to decide, whether such a provision constituted a proper deduction in the ascertainment of the Company's profits for Income Tax purposes. The Commissioners, adopting that evidence, held that it was "a matter of correct accountancy practice in England" to make such provision. But this carries the matter no further, for no view could be formed as to the propriety of the deduction of the amount of such provision for Income Tax purposes without first arriving at some conclusion as to the effect of the social legislation in the two vital respects above discussed, namely, whether the Company's liability for compensation prospectively payable was certain or contingent, and whether each year's increment in such compensation represented remuneration attributable exclusively to services rendered during that year. Indeed, the Commissioners prefaced their conclusions with what amounted in effect to a disclaimer of any view as to the correct legal description of the Company's obligation under Peruvian law, which they later qualified only to the extent of finding that the compensation was according to Peruvian law deferred remuneration. That finding, as I have endeavoured to show, was not in my opinion sufficient in law to support their conclusion, even though there

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was no statutory prohibition against the deduction, and even though the provision made may have been in accordance with correct accountancy practice. The reference made by the Commissioners to Peruvian income tax law is, so far as I can see, wholly irrelevant.

For these reasons, which are substantially in accord with those given by the learned Judge, I think that the Special Commissioners misdirected themselves and came to a wrong conclusion in this case.

Accordingly, I would dismiss this appeal.

Romer, L.J.—I agree.

“It is plain”

said Lord Haldane in *Sun Insurance Office v. Clark*, 6 T.C. 59, at page 78,

“that the question of what is or what is not profit or gain must primarily be one of fact to be ascertained by the tests applied in ordinary business.”

It has, however, been authoritatively recognised that deductions from gross profits in a trading company's accounts for any particular year are not necessarily permissible for the purposes of assessment to Income Tax merely because they conform to ordinary accountancy practice. As Lord Porter pointed out in *Ryan v. Asia Mill, Ltd.*, 32 T.C. 275, at page 296,

“what may be prudent accountancy for a company is not necessarily the correct method of ascertaining the proper assessment for Income Tax.”

Nevertheless the accepted practice of accountancy is obviously deserving of considerable weight in ascertaining what is the sum which should be regarded as the profit of a company for any given year.

In the present case the Special Commissioners found that

“it was a matter of correct accountancy practice in England to make provision in the accounts for the sums in question in the circumstances of this case.”

That finding, being one of fact, cannot be disturbed if there was evidence before the Commissioners to support it. Upjohn, J., held that there was in truth no such evidence and said that the only evidence of commercial practice which was before the Commissioners, so far as appeared from the Stated Case, was that the auditors of the Company refused to sign the balance sheet without qualification unless provision for the deferred payments was made. In point of fact the evidence of the auditors went further than this, as appears from paragraph 3 (5) of the Case which shows that the auditors indicated that the reason why they would not have signed the balance sheet without a qualification unless the aforementioned provision had been made was because the making of such provision in the circumstances was the correct accountancy practice. It follows, I think, that the Appellants are justified in their submission that there was some evidence to support the view that an annual deduction in respect of these deferred payments was in accord with ordinary accountancy practice and that this case must therefore be approached upon that footing.

This, however, as I have already indicated, is not in itself sufficient to enable the Appellants to succeed; for they must further establish that the deductions are proper to be made for the purpose of ascertaining the taxable profits of the Company.

In order to arrive at a conclusion as to whether the deductions are or are not permissible for this purpose it is necessary to inquire whether they formed a part of the cost to the Company of earning their total profits for each of the years in which such deductions were made. This was the test

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which Lord Atkinson applied in the *Sun Insurance* case (at page 82 of the report⁽¹⁾) where he said:

"it is what remains of those receipts after there has been deducted from them the cost of earning them which constitute the taxable profits and gains."

No rule of law governs the question of what deductions may be made from gross profits as representing the cost of earning them. As Lord Loreburn observed in the *Sun Insurance* case (at page 77) the only rule is that

"the true gains are to be ascertained as nearly as it can be done."

Nevertheless certain principles have become established and may be relied upon as general guides. Liabilities which are merely contingent cannot be deducted from gross profit for the purpose of tax assessment (see, for example, *Peter Merchant, Ltd. v. Stedeford*, 30 T.C. 496, and *H. Ford & Co., Ltd. v. Commissioners of Inland Revenue*, 12 T.C. 997); it is not until the provisional liability has become established as an actual liability that, for tax purposes, it warrants inclusion as a debit entry in the accounts. The Lord President, Lord Cooper, dealt with this aspect of taxation in *James Spencer & Co. v. Commissioners of Inland Revenue*, 32 T.C. 111, where he said⁽²⁾:

"the broad working rule which emerges as a guide for the crediting or debiting in a tax computation of subsequently maturing credits or debits is to enquire in which accounting period the right or liability was established and to carry the item into the account in that year . . . if in the earlier period there is only a provisional or contingent 'liability', it is not until it has been subsequently determined to be an actual 'liability' by admission or decision that it can properly be brought into computation, and it should then be debited even if it is not until a still later period that the exact quantum can be inserted, if need be by re-opening the accounts."

The right to receive, or the liability to pay, trade debts, or debts analogous thereto, fall to be computed for tax purposes in the year in which the liability to pay, or the right to receive (as the case may be), arose and notwithstanding that the date for actual payment of the money is outside the year. In *Johnson v. W. S. Try, Ltd.*, 27 T.C. 167, Lord Greene, M.R., expressed the view (page 181) that in one sense this principle

"is an anomaly, because it is a departure from what I have always understood to be the fundamental conception of Income Tax legislation—that you ascertain your profits in reference to your receipts."

The principle is, however, well settled and is in fact in harmony with Lord Cooper's views which I have quoted above. The principle is equally applicable to the payment, as to the receipt, of a trade debt and Lord Greene indicated that a debt might be regarded as being analogous to a trade debt when the amount was immediately owing, though it could only be ascertained in future; where nothing further remained to be done in order to obtain it; and where there were no contingencies which could affect or destroy or cut down the right to receive it. These observations of Lord Greene were made with reference to *Ensign Shipping Co., Ltd. v. Commissioners of Inland Revenue*, 12 T.C. 1169—a case in which two ships belonging to a company were detained in port by order of the Government after the coming into force of an Indemnity Act which conferred an automatic right of compensation; and reliance was placed upon the observations by the Appellants in the present case.

With such guidance, then, as is afforded by the authorities to which I have referred I turn now to the Appellant Company's submissions. Some

(1) 6 T.C. 59.

(2) At pp. 116-7.

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of the Company's employees have, so we were told, three-year service contracts but the great majority of them have no fixed term agreements and it was in relation to this majority that Mr. Pennycuick's and Mr. Bucher's arguments were primarily addressed. Their contentions may be summarised as follows. They said that the Appellants were under no obligation to establish that their system of annually deducting the sums in question is the best or the only system which could be adopted and that they need only show that it is in accordance with recognised accountancy practice and that the result of applying it is to disclose, properly and fairly, the trading profits of the Company for each year. They contended that at the end of each year of an employee's service the Company comes under a commercial liability to make a future payment to him for the services which he has rendered during that year; that the amount of that payment is known and definite in that it can never be diminished, though it may be increased in the event of the servant being subsequently promoted to a post carrying a higher wage; and that future payment of that sum to the servant is in no way dependent upon the employee rendering any further services to the Company. The liability of the Company at the end of each year is a definite and not a contingent liability and the reasoning of (for example) *James Spencer & Co.'s case*⁽¹⁾ accordingly applies. The hiring of the employee's services, it is argued, was analogous to the purchase by the Company of goods under a contract which provided for payment of the purchase price during a future accounting period and thus attracts the principle applicable to trade debts which Lord Greene explained in the case of *W. S. Try, Ltd.*⁽²⁾ Whatever way one looks at the matter, Counsel contended, the only reasonable conclusion is that the annual deferred payments represent outgoings which are properly and exclusively incurred for the purpose of earning the annual profit and accordingly pass the test which was formulated by Lord Atkinson in the *Sun Insurance case*⁽³⁾. As to the contingency that a servant might be dismissed in circumstances which would deprive him of compensation altogether the Appellants say that this may fairly be disregarded in view of the Commissioners' finding in paragraph 3 (6) of the Case that no instance had yet occurred in which the Company had refused to pay an employee or workman the compensation provided for in the social legislation on any ground. Similarly the contingency of a servant forfeiting his right to compensation by voluntarily leaving without due notice should also be ignored having regard to the extreme improbability of any employee taking a step which would or might bring about this result.

The argument for the Crown, on the other hand was, in brief, that for purposes of Income Tax assessment it is necessary to ascertain the profit of the Company for each individual year of account and that the only permissible deductions which may be made from the gross profits for that year are those which can fairly be regarded as expenditure which has been incurred for the purpose of earning that year's profits; that the deductions made by the Company in each year with reference to the deferred remuneration were not necessary in order to earn the profits which were earned in that year; that the deferred remuneration is only contingently payable and if and when paid is referable to the whole period of the employees' service and cannot be divided up and allocated to the different years which together constitute that period; and that therefore the proper method to adopt, and the only one which truly reflects the taxable annual profit of the Company, is to wait until compensation becomes actually payable and then charge the whole amount of it against the profits for the year in which it is paid.

⁽¹⁾ 32 T.C. 111.⁽²⁾ 27 T.C. 167.⁽³⁾ 6 T.C. 59.

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The learned Judge, differing from the Special Commissioners, accepted the contentions of the Crown.

Now, leaving aside for the moment the position of the Company's servants who are employed on fixed term contracts, it appears to me on the whole that if it could be said of the deferred remuneration payable to the other employees that such employees became absolutely entitled to it upon entering the Company's service subject only to having to wait until a future date to receive it then it would be right and proper for the Company to debit their gross receipts with the appropriate minimum amount in each year in order to make provision for it. The reason for this is that, in such case, the Company would be incurring an unconditional liability in each year which they would be bound to discharge in the future; and the principle adumbrated by the Lord President in *James Spencer & Co.'s case*(¹) would, as it seems to me, apply. The position on this hypothesis, would, I think, be that each annual debit would represent part of the price which the Company were paying for the services of their employees during that year, and could be assimilated to the purchase by the Company of goods for a future payment. It is true that the system would produce unexpected results, one of which would be that in the illustration suggested by the learned Judge in his judgment of an employee receiving £600 a year for five years followed by £1,200 a year for five years the Company would be paying £350 deferred remuneration for the sixth year of his service but only £50 per annum for the first five years and £100 per annum for the last four years. This anomaly seems to me to lend considerable support to the view that the allocation of these sums of deferred remuneration to particular years is not in accordance with the realities of the case. Nevertheless, on the hypothesis which I am now considering, I am by no means clear that the Company would not be entitled to make these annual debits for the purpose of arriving at the taxable profit notwithstanding this and other possible anomalies— anomalies which, it is to be noted, arise out of the somewhat peculiar provisions of the relevant legislation. This view is, however, subject to its being reasonably practicable to discount the annual debits down to the present value of future payments—a point to which I return hereafter.

Whether or not, however, I am right in the opinion which I have tentatively expressed the hypothesis upon which it is formed does not reflect the true position which exists under the social legislation in question. The employees have no unconditional right to the deferred remuneration which that legislation prescribes. The Company's servants who are not employed under fixed term contracts (and it is those servants only that I am considering at the moment) may leave the Company's employment in circumstances which exclude them from any claim to compensation whatever. If such a servant leaves the Company without having first given the requisite notice of his intention to do so, or if he is discharged by the Company on any of certain specified grounds, he forfeits all right to the statutory compensation. It is true that in a sense a servant acquires at the end of each year a vested interest in a future payment equivalent in amount to at least one-twelfth of the wage which he received during that year and that that interest is only liable to be divested or defeated by the occurrence of some event which may or may not happen in the future. For example, a man enters the Company's service at an annual wage of

(¹) 32 T.C. 111.

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£360; at the end of the first year of his employment he not only has a right to receive a further sum of £30 in the future but can obtain almost immediate payment of that sum by the simple expedient of giving 40 days' notice terminating his employment and behaving himself until that notice has expired. Nevertheless if he continues in the Company's service, even for years, he is liable to forfeiture of that £30 if grounds for forfeiture arise so that it can never be postulated that he has an absolute right *in futuro* to receive payment of that sum. It appears to me, therefore, that there can be no justification for the Company to debit its gross profits with a sum which it is under no present obligation to pay and which it may never be under any legal obligation to pay in the future. It has been found by the Special Commissioners that no instance has ever occurred of an employee being deprived of compensation on his leaving the Company's employment for any reason. This, however, is presumably a mere matter of policy and policies may change from time to time; and one may well imagine that if a practice of men leaving voluntarily without giving notice became at all prevalent the management would be compelled to withhold compensation as a deterrent. In any case the current practice of the Company in the matter cannot affect their legal rights, or those of their servants, under the legislation and the fact remains that if a man leaves without due notice or is discharged on any of the grounds which the legislation specifies he has no right in law to any compensation at all. How, then, in the illustration which I have mentioned, can it be legitimate for the Company to deduct against its profits a sum of £30 which it is under no legal obligation to set aside immediately and which may never leave its coffers at all? It may be reasonable commercial practice for the directors to deduct the sum for the purpose of arriving at a net profit for distribution among the shareholders but that is not the point; the point is whether they are entitled to deduct it as against the Crown for the purpose of arriving at the profit on which they are liable to be taxed and in my opinion they are not, for the sums, being neither payable at once nor certainly payable in the future, cannot rightly be regarded as part of a definite price which the Company has to pay for the services of the hypothetical servant during the year of deduction or, indeed, during any particular year.

In my opinion accordingly, and in the light of the authorities to which I have referred, the Crown are right in this case if only for the reasons which I have endeavoured to state when taken by themselves. In point of fact, however, even if the Company were entitled, as a matter of principle, to make some annual deduction from their profits in respect of the deferred remuneration the actual position which they sought before the Commissioners to sustain is untenable, in my judgment, for two separate, although analogous, reasons. The first is that in none of the accounting years which are in question have the deducted sums been subjected to discount notwithstanding that many years might elapse before the sums would become (if they ever should become) payable to the employees. In my illustration, for example, the Company would deduct the whole of the £30 from its gross profits notwithstanding that the servant might continue in their employment for another twenty-five years or more. This, I should have thought, is plainly wrong even from a commercial point of view. Mr. Pennycuik told us that he was instructed that the sums could be actuarially discounted—presumably by averaging the length of service of the employees as a whole. Be that as it may, the whole of the sums in question have been brought into account as though they were payable at once and this cannot, in my

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opinion, in any event be justified. Mr. Pennycuick submitted that this point, which was not, apparently, considered by the Commissioners, ought to have been taken by the Crown if it was going to be taken at all. I cannot, with respect, agree with him. It was for the Company to justify the deductions which they claimed and if they could not justify them altogether it was for them, and not for the Crown, to justify them in part if they could.

The second reason is that no allowance is made, in deducting the deferred remuneration in the accounts, for the possibility that it will never become payable at all. Whether or not this possibility can properly be ignored from a commercial standpoint it cannot, in my judgment, be legitimately ignored for the purpose of ascertaining the taxable profit in each year of the Company. So far as I am aware no evidence was given before the Commissioners directed to showing that an actuarial calculation could be made which would reasonably reflect the possibility; and in the absence of such evidence I feel the gravest doubts as to whether any such calculation is feasible. At all events no attempt has ever been made to evaluate the possibility and this omission presents a difficulty in the Company's way which they cannot, in my opinion, easily surmount.

I realise, and have already intimated, that the Commissioners' finding, founded upon the auditors' evidence, that the Company's system of annual deduction for deferred remuneration accords with ordinary accountancy practice cannot be disturbed. Nevertheless, had the auditors' attention been directed to the compound difficulty of discounting both for future payment and for the possibility of no payment having to be made at all it is permissible to wonder whether their evidence upon this question might have been somewhat modified.

When the case was before the Special Commissioners it would appear that no distinction was made between deductions which the Company had made in respect of servants who had fixed term contracts on the one hand and those who were employed without such contracts on the other. The only material difference, for present purposes, between the two classes of servants is that the first has to satisfy one additional condition in order to qualify for compensation, namely, the condition of giving faithful service to the Company until the end of a specified period. This condition involves an added element of contingency in the right to receive the compensation and in the Company's corresponding liability to pay it; and it follows that if I am right in my view that no annual deductions are permissible in relation to the second class then *a fortiori* none is permissible in relation to the first.

I am accordingly of opinion that Upjohn, J., came to a right conclusion in this case, and I would only add one further observation. If the learned Judge's decision be upheld the result is that the amount which the Company is entitled in each year to deduct from its profits for purposes of tax is the amount which it has in fact paid out in the way of compensation during that year. The amount so paid during any particular year (£X) will rarely, if ever, be the same as the sum (£Y) which the Company seeks to deduct for the same year. Yet it cannot be said that it would equally be right, in order to arrive at taxable profit, to deduct either £X or £Y indifferently. If one is right then the other, and the system from which it derives, is wrong. Inasmuch as £X is factual and £Y is, in substance, hypothetical the former is *prima facie* to be preferred. Mr. Pennycuick

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argued that over a period of years both systems would produce the same result so that £X × 20 would be found to be equivalent to £Y × 20, and that therefore it really does not matter whether one adopts the system which produces £X in any given year or that which produces £Y. Whether or not in the long run both systems would produce substantially the same result I do not really know but even if they did it would, I think, be irrelevant; for, as I have already intimated, the Crown is entitled to tax on the profits of each year, taken in isolation by itself, and not on the average profits of a number of years.

For the above reasons this appeal should, in my opinion, be dismissed.

Mr. C. Montgomery White.—Your Lordships will dismiss the appeal with costs?

Mr. John Pennycuick.—My Lord, that I cannot resist, but I would ask your Lordship for leave to appeal to the House of Lords in this case.

Sir Raymond Evershed, M.R.—Mr. Montgomery White, the Crown does not usually offer any observations upon that matter?

Mr. Montgomery White.—No. I leave it entirely to your Lordships' decision.

Sir Raymond Evershed, M.R.—We think we should give leave.

Mr. Pennycuick.—If your Lordship pleases.

The Company having appealed against the above decision, the case came before the House of Lords (Earl Jowitt and Lords Oaksey, Radcliffe, Tucker and MacDermott) on 23rd, 24th, 25th and 26th April, 1956, when judgment was reserved. On 21st June, 1956, judgment was given in favour of the Crown, with costs (Lord MacDermott dissenting).

Mr. John Pennycuick, Q.C., Mr. F. N. Bucher, Q.C., and Mr. M. P. Nolan appeared as Counsel for the Company, and the Attorney-General (Sir Reginald Manningham-Buller, Q.C.), Mr. C. Montgomery White, Q.C., and Sir Reginald Hills for the Crown.

Earl Jowitt.—My Lords, I have had the advantage of reading the opinion which is about to be delivered by my noble and learned friend, Lord Radcliffe, with which I agree, and have nothing to add.

Lord Oaksey.—My Lords, I agree that this appeal should be dismissed.

Mr. Pennycuick, in his able argument for the Appellants, contended that the social legislation of Peru conferred upon the Appellants' employees a right to the compensation therein referred to in the year of taxation and that, as an employee could at any time give the requisite period of notice and claim the compensation at the expiration of that period, the amount of compensation which would then be due was a sum which the Appellants were entitled to charge against the profits of the year although, in fact, the employee had given no such notice during the year. In my opinion the fallacy of this argument lies in the fact that the employees whose compensation the Appellants sought to charge against their profits had not, as a matter of fact,

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given their notices or terminated their contracts, and it is clear, and not disputed, that no compensation was payable to them until their service was duly terminated. The Peruvian legislation contains certain provisions which entitle the Appellants to dismiss their employees for misconduct, and it is clear that until the contract of service is duly completed no liability to pay the compensation arises.

Reliance was placed during the argument upon *Sun Insurance Office v. Clark*, 6 T.C. 59, in which this House held that a percentage of the premium income of an insurance company might be deferred as a receipt to a future year because it was paid as consideration for future liability, but the principle of that decision is not, in my opinion, applicable to the present case. The premium income was only deferred and would suffer tax in a future year, whereas in the present case if the Appellants are permitted to deduct compensation which they have not paid and which they may never have to pay that compensation will escape tax altogether. There is, in my opinion, a fundamental distinction between a contingent liability and a payment dependent upon a contingency. When a debt is not paid at the time it is incurred its payment is, of course, contingent upon the solvency of the debtor but the liability is not contingent. Similarly, the liability in the *Sun Insurance* case was not, in my opinion, contingent but remained in force throughout the period of the insurance, though payment in pursuance of that liability might or might not have to be made. The circumstances in the present case may put an end to the liability altogether, but in the case of insurance for a period the circumstance of loss does not put an end to the liability but merely makes payment obligatory in pursuance of the liability. After all, the only question in the present case is whether the compensation should be deducted when it is in fact paid or should be deducted before it is paid and in circumstances in which it may never be paid. In my opinion, the reasoning and the judgments in the Court of Appeal are correct and should be affirmed.

Lord MacDermott.—My Lords, in this appeal the Appellant claims that, in the computation of its profits for each of the years of assessment under review, an allowance should be made in respect of its liability to pay to the employees then in its service in Peru certain lump sums which, under Peruvian legislation, those employees will be entitled to receive from the Appellant on the due completion of their service. The appeal is therefore concerned with payments to be made after—and it may be long after—each of the relevant accounting periods has ended. No question arises as to the deduction of wages and salaries currently paid for services rendered. What the Appellant contends is, in effect, that the total cost of those services each year included, in addition to current wages and salaries, a provision to meet the amount by which the services rendered that year have enhanced the lump sums that will eventually be payable under the Peruvian legislation. In short, the Appellant maintains that its employees earn each year a deferred as well as a present remuneration and that the former, no less than the latter, must be taken into account if the true yearly profits are to be ascertained for the purposes of taxation.

My Lords, as a general proposition it is, I think, right to say that in computing his taxable profits for a particular year a trader who is under a definite obligation to pay his employees for their services in that year an immediate payment and also a future payment in some subsequent year, may properly deduct not only the immediate payment but the present value of the future payment provided such present value can be satisfactorily

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determined or fairly estimated. Apart from special circumstances, such a procedure, if practicable, is justified because it brings the true costs of trading in the particular year into account for that year and thus promotes the ascertainment of the "annual profits or gains arising or accruing from" the trade. As I read the judgments, the substance of this proposition was accepted in the Court of Appeal; and before your Lordships the Crown, without making any formal concession, was not concerned to argue strenuously against it. The Crown's contention, and the view taken in the Courts below, was rather to the effect that the proposition did not apply to the Appellant's case because (1) the Appellant was not under a definite obligation in any relevant year to pay its employees lump sums at the end of their engagements, since in each individual instance the right to receive a lump sum depended upon the fulfilment of certain conditions that made the Appellant's prospective liability contingent until the service was duly terminated; and (2) it was impossible in the circumstances to regard any part of the lump sums as earned in or payable in respect of any particular year of service.

The first of these arguments necessitates a reference to the effect of the relevant Peruvian legislation. This was summarised in the Court of Appeal by Jenkins, L.J., in two paragraphs which were accepted by both parties and which read as follows⁽¹⁾:

"1. 'In the event of', that is, 'upon' the determination of any service contract between the Company and any employee, whether from the employee's death, expiry of the term, or notice of determination given on either side, the Company is liable to pay compensation calculated as later appears to the employee or his representatives.

2. The above general proposition is subject to exceptions:—(a) in the case of fixed term contracts where the contract has been determined by the employee before expiry of the term otherwise than on account of infringement by the Company; and (b) in the case (apparently) of all contracts of service where there has been wrongful conduct of certain kinds by the employee. e.g., dishonesty or insubordination."

The position, therefore, was that the Appellant's liability to pay a lump sum could only be avoided by some breach of contract or grave misconduct on the part of the employee concerned. It may be correct to call such a liability contingent, but I must say the contingency seems to me to be too remote to justify a prudent trader or, for that matter, a competent accountant, in ignoring the liability until the day for payment has arrived. Whether, if this appeal related to but one employee and one lump sum, the degree of the contingency would, nevertheless, be such as to preclude a present allowance in respect of the future liability is a question which, in my opinion, does not call for decision on the facts of this case. I do not forget that the Court of Appeal looked at this contingency argument from the point of view of the individual employee and may, therefore, be taken as of a different opinion. With respect, however, I think that that was the wrong approach, or perhaps more accurately that it should have been taken a stage further. The question, as I see it, on this branch of the case was not whether, in a given year, the Appellant's liability to pay this employee or that was contingent: it was whether the Appellant's liability to make some payment in respect of the lump sums accruing for the benefit of all its employees in that year was in any relevant sense contingent. If that is the right view, I think the Crown's contention on this point must fail. It is clear from the accounts that the Appellant's employees during the material years were numerous and the chances of all, or even a

⁽¹⁾ See page 618 *ante*.

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substantial proportion of them, acting so as to forfeit their lump sum rights seem to me to be much too distant and improbable to merit significance. Here the case bears a close resemblance to the state of affairs with which this House had to deal in *Sun Insurance Office v. Clark*, [1912] A.C. 443; 6 T.C. 59. There the taxpayer, a fire insurance company, was held entitled, in determining its taxable profits, to deduct from its premium income for the year an allowance for unexpired risks on policies outstanding at the end of the year. Forty per cent. of the premium income was accepted as a fair and reasonable estimate of such risks, and the deduction was allowed as a proper method of ascertaining the true gains for the year in which the premiums were paid. Liability on each outstanding policy was, of course, highly contingent. But that there would be a loss on the collective risk was a matter of commercial certainty. On the facts, the situation in this appeal appears to me to be essentially the same. However one may describe the Appellant's liability as respects the lump sum which may become payable to a single employee, its liability to make some payment at a future date on foot of the body of presently accruing lump sum rights cannot well be regarded as contingent within the world of ordinary business affairs. Whether this future liability can be quantified for the purposes of taxation is another matter; but in the degree of its certainty it is not, in my opinion, to be distinguished in any material respect from the future liability which was taken into account in the *Sun Insurance Office* case. It was said that that decision related only to insurance business and had no application to the facts of this appeal. I see no reason for confining the scope of the decision in this way. Its *ratio* is much wider than that, and is in my view applicable to cases producing the same sort of problem, whether they relate to contracts of insurance or not.

The Crown's second submission raises a very different and, as it seems to me, a more difficult issue. It turns on the true nature of the lump sum payment made to an employee at the end of his service. If the correct view were that such payment should be regarded merely as a statutory bounty, as something independent of the length or value of the services rendered except for arithmetical purposes, I should, as at present advised, find it difficult to resist the Crown's claim that it could only be allowed for in the year of payment; on this hypothesis it would be a trading expense of that year and not, I think, of any other year. It is, however, clear that such is not the nature of the payment in question. The Crown conceded that it was deferred remuneration, and that is what the Special Commissioners and the Court of Appeal have held it to be. As Jenkins, L.J., put it⁽¹⁾:

"The right to this compensation is regarded as part of the remuneration for the services rendered by the employee."

There can, I think, be no doubt that this accords with the tenor of the Peruvian legislation. Thus, Law No. 6871, having made provision for the calculation of the lump sum in Article 1 (as modified)

"at the rate of one month's salary per yearly service time",

says in Article 2:

"Payment, such as is referred to in the foregoing article, from the legal viewpoint, represents a remuneration which the employer pays for the work of his employee, whether the latter's engagement is for an indefinite period or for a fixed time";

⁽¹⁾ See page 618 *ante*.

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and Law No. 9463, speaking in the same strain, adds:

"The reduction in remuneration accepted by an employee shall not impair in any way the rights acquired for services rendered . . . as compensation should be calculated per years of service in accordance with the remuneration received until the time of the reduction. Following compensation will be calculated in accordance with the reduced remuneration."

The lump sum payment has, therefore, to be regarded as deferred remuneration in respect of the entire period of service. This at once puts an obstacle in the way of debiting the whole sum in the accounts for the last year of service, as the Crown contends should be done, since to do so would be to inflate the cost of the services rendered for that year beyond the actual figure and thus produce a corresponding error in the amount of the annual profits. This obstacle may not conclude the matter and the error it induces may have to be accepted if no better way of computing the true profits is open. But before that can be conceded a negative answer must be found to one or other of two questions. The first of these, which is that raised by the submission under consideration, comes to this: can the amount of a lump sum payment properly be regarded as made up of parcels each of which is attributable to a particular year of service? And the second question is whether, if the lump sum can be allocated in that manner, a fair estimate can be made for each year of the provision required to meet the prospective liability.

My Lords, the first of these questions would present little difficulty if each lump sum was simply the amount found by adding together a twelfth part of the remuneration actually paid in each year of service. In that event the method of computation, coupled with the circumstance that the lump sum is to be regarded as deferred remuneration, would seem to relate the payment to each year of service almost automatically. But that is not the scheme of the Peruvian legislation, the effect of which, in this connection, is thus summarised by Jenkins, L.J.⁽¹⁾:

"The compensation is an amount equivalent to one month's salary or one-twelfth of a year's salary at the rate in force at the date of determination for every year of service, provided that the right to compensation accrued up to any point of time is not liable to be diminished in amount by subsequent reduction in pay."

This provision undoubtedly leads to anomalies if one is to regard each year's accretion to a lump sum as remuneration earned in that year, the possible effect of an increase of remuneration (to take what is perhaps the most glaring example) being to raise the increment for the year of increase above that of subsequent as well as previous years. It is, I think, true to say that this consideration led Upjohn, J., and, in the Court of Appeal, Jenkins, L.J., to hold against the Appellant on this aspect of the matter. But, while I find the point far from easy, I am of opinion that the anomalies referred to have been given more than their due weight and that the true view is that the yearly increments by which a lump sum is built up ought to be reckoned for present purposes as remuneration in respect of the years in which they accrue. It must be remembered that the anomalies are the result of a statutory scheme and that the criterion of what is sensible or reasonable contractually does not arise. Moreover, if, as I think, the lump sum is to be regarded as deferred remuneration in respect of the entire service, the case for relating each incremental step to the remuneration for the year in which it occurs cannot be lightly disregarded. After all, and whatever may be said of the manner in which the increments may fluctuate in amount, the scheme is such that at the end of each year an employee can tell with certainty not only what his

⁽¹⁾ See page 619 *ante*.

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lump sum will be if he then retires and does not forfeit his rights, but also how much each year of previous service has added to his entitlement. And finally, the language of Law No. 9463 with its reference to "rights acquired for services rendered" in a context relating to a point during the service and not at its end, goes at any rate some way to show that the legislation regarded the lump sum as accruing throughout the service.

For these reasons I consider that the Crown has failed in both the submissions discussed and, accordingly, I would hold that the Appellant was right in contending that in principle it was entitled to make a deduction each year in respect of its prospective lump sum liabilities, provided such deduction can be fairly estimated or otherwise satisfactorily assessed.

There remains the question which this proviso raises and which I have already posed. The difficulty here is that the deduction sought by the Appellant throughout has been the aggregate of the yearly increments by which the value of the future lump sum payments has been increased. That, I think, must be wrong as, apart from any adjustment to be made on account of possible forfeitures, this deduction makes no attempt to reflect the present value of payments which may not have to be made for anything up to the span of a man's industrial life. If the position is that no fair estimate or satisfactory computation of the provision to be made as respects the Appellant's prospective liabilities can be arrived at, then that is an end of the matter and the appeal must be dismissed. I am not disposed, however, to assume that that is the position or that it is beyond the power of those skilled in such matters to produce a series of acceptable deductions for the years affected by these proceedings. I express no opinion as to whether or not this can be done. I do not know. But on the whole I feel the Appellant should have an opportunity of putting this question to the test. If one may judge from the terms of the Case Stated, it was not debated before the Special Commissioners, and it must, I think, have been obscured in the Courts below by the other issues which were the subject of a vigorous controversy throughout and were decided, wrongly as I consider, against the Appellant. While I appreciate that your Lordships would be reluctant to take any step likely to start this litigation on a further round of the Courts, the outstanding point is now so much a matter of fact that there is, I think, but little danger of this. For my part, therefore, I would favour a remit to the Special Commissioners to ascertain whether it is practicable to arrive at satisfactory deductions and, if so, to determine what they should be.

Lord Radcliffe.—My Lords, the Appellant has been operating its railway in Peru under the obligations of a statutory scheme by virtue of which its employees, generally speaking, are entitled to receive from it a lump sum payment on retirement, death or other termination of service. In effect, entitlement does not depend on any prescribed length of service: on the other hand, an employee can forfeit his right to payment by wrongful conduct such as dishonesty or insubordination, or by failure to give due notice of retirement, which in many cases is only a short one. Employees on fixed term contracts must complete their term without breach, except in the case where the Company itself is in default.

In my opinion, the solution of this case does not depend on any precise analysis of the Appellant's obligations under Peruvian law. In this I am at one with the Special Commissioners, who have set out in the Case all that it is necessary to know on this point. It amounts, I think,

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to this. The payments that fall due are retirement benefits and no payment is exigible from the Company until service has been terminated. The amount of benefit is arrived at by taking a prescribed proportion of the salary of the closing year and multiplying it by the number of years of service, but this calculation is subject to a not unimportant proviso to the effect that if an employee's rate of salary or wage is reduced during the course of his service the reduction

"shall not impair in any way the rights acquired for services rendered . . . as compensation should be calculated per years of service in accordance with the remuneration received until the time of the reduction. Following compensation will be calculated in accordance with the reduced remuneration."

(Law No. 9463). Thus, what is paid in the year of retirement is paid in respect of the whole period of service and is indeed declared to represent

"a remuneration which the employer pays for the work of his employee"

(Law No. 6871). On the other hand, it is a single sum, and I do not think that it can be said that any particular part of what is paid is in law the earning of any particular year. It might be plausible to say so in the case of a salary that never varied, but such a description cannot really be made to fit the case of the salary that increases from time to time during the period of service.

Now, the question is, how ought the effects of this statutory scheme to be reflected in the Appellant's accounts of the annual profits arising from its trade? One way, which is certainly the simplest one, is to let the payments made fall entirely as expenses of the year of payment and ignore any question of making provision for the maturing obligation during the years of service that precede it. This is what the Company seems to have done up to the year ending 30th June, 1947, and it is the system which is, according to the Crown, the only one which the law of Income Tax permits. It has one considerable advantage: no element of estimate or valuation appears in the profit assessment and nothing is charged to profits except the actual cash outgoing. But, when this has been conceded, I think that there is the very serious disadvantage to be set against the cash basis that it affords a comparatively inefficient method of arriving at the true profits of any one year. The retirement benefit is not, obviously, paid to obtain the services given in the year of retirement. The incidence of retirement payments must be variable from year to year, and they may inordinately depress the profits of one year just as they may inordinately inflate the profits of another. It is true that the Company carries on business from one year to another, but it is not charged on the average of its annual profits. Tax rates and allowances themselves vary and, apart from that, to charge tax on a profit unduly accelerated or unduly deferred is, in my opinion, no more respectable an achievement than to admit that the annual accounts of business do in some cases require the introduction of estimates or valuations if a true statement of profit is to be secured.

Another method is that which the Appellant is seeking to establish with regard to its assessments for the four years 1947-50. I will say at once that what it aims at (I do not say, what it achieves) appears to me to be a more accurate assessment of true annual profit than that which could be provided by the other method. When I am told, then, that its adoption is banned by some established principle of law, to which your Lordships are bound to give effect, I feel that I must enquire closely what that principle of law is and upon what understanding of accountancy practice the principle is said to be based. For the overriding principle of law is still, I believe, as it was stated by Lord Haldane in *Sun Insurance Office v. Clark*, 6 T.C. 59, at page 78:

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"It is plain that the question of what is or is not profit or gain must primarily be one of fact and of fact to be ascertained by the tests applied in ordinary business. Questions of law can only arise when (as was not the case here) some express statutory direction applies and excludes ordinary commercial practice, or where, by reason of its being impracticable to ascertain the facts sufficiently, some presumption has to be invoked to fill the gap."

And our task is not made any easier by the knowledge that, though the law with its system of precedents may sometimes seem to stand still (I hope that it does not), it is quite certain that the techniques and practices of commercial accountancy are very far from static.

What the Appellant claims the right to do is to charge against each year's receipts the cost of making provision for the retirement payments that will ultimately be thrown upon it by virtue of the fact that it has had the benefit of its employees' services during that year. As a corollary it will not make any charge to cover the actual payments made in the year in respect of retirement benefits. Only by such a method, it is said, can it bring against the receipts of the year the true cost of the services that it has used to earn those receipts. Generally speaking, this must, I think, be true. For whereas it is possible that any one of its many employees may forfeit his benefit and so never require a payment, the substantial facts of the situation are that when the Company has paid every salary and wage that is due for current remuneration of the year it has not by any means wholly discharged itself of the pecuniary burden which falls upon it in respect of the year's employment. This is a long-term application of the practice by which provision for holidays with pay in the coming year is charged in part against the receipts of the previous year. It does not seem to me inconsistent with the theory on which the claim is based that in the year when an increase of salary takes place and the expectation of a larger ultimate payment materialises an adjustment has to be made to take care of what has thus become the under-provision of earlier years. I agree that it is arbitrary to describe such an adjustment as accruing in respect of that year's service, but on the other hand it is a provision which is required in that year to take account of the increased burden which the year's salary for the year's service has thrown upon the employer.

Of course, the Company's claim must be understood in the light of the fact that it is an employer dealing with the cost of services rendered to it, by which it itself has received moneys, say fares and freights, which enter into the current year's receipts. Generally speaking, I suppose, its takings are cash or short-term credits. The considerations which apply to this situation are not necessarily valid in other fields of income or expenditure. But in this field I agree that provision for retirement payments is more likely to give an accurate reflection of the true cost of earning the year's receipts than merely charging against them the year's payments to employees who retire in the year.

The courts have not found it impossible hitherto to make considerable adjustments in the actual fall of receipts or payments in order to arrive at a truer statement of the profits of successive years. After all, that is why income and expenditure accounting is preferred to cash accounting for this purpose. As I understand the matter, the principle that justified the attribution of something that was in fact received in one year to the profits of an earlier year, as in such cases as *Isaac Holden & Sons, Ltd. v. Commissioners of Inland Revenue*, 12 T.C. 768, and *Commissioners of Inland Revenue v. Newcastle Breweries, Ltd.*, 12 T.C. 927, was just this, that the payment had been earned

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by services given in the earlier year and therefore a true statement of profit required that the year which had borne the burden of the cost should have appropriated to it the benefit of the receipt. The principle is clearly stated in the speech of Lord Simon in *Commissioners of Inland Revenue v. Gardner Mountain & D'Ambrumenil, Ltd.*, 29 T.C. 69, at page 93:

"In calculating the taxable profit of a business on Income Tax principles . . . services completely rendered or goods supplied, which are not to be paid for till a subsequent year, cannot, generally speaking, be dealt with by treating the taxpayer's outlay as pure loss in the year in which it was incurred and bringing in the remuneration as pure profit in the subsequent year in which it is paid, or is due to be paid. In making an assessment to Income Tax under Schedule D the net result of the transaction, setting expenses on the one side and a figure for remuneration on the other side, ought to appear (as it would appear in a proper system of accountancy) in the same year's profit and loss account, and that year will be the year when the service was rendered or the goods delivered . . . This may involve, in some instances, an estimate of what the future remuneration will amount to (and in theory, though not usually in practice, a discounting of the amount to be paid in the future) . . . If the accounts . . . were made up before the amount of the commission was ascertained, a provisional estimate of what the amount would be might be inserted in the first place and could be corrected, when the precise figure was known, by additional assessment or by a return of any excess within six years of the original assessment."

Lord Simon's principle is not stated in terms which fully cover the present case, for he speaks of "services completely rendered". Moreover, the decisions I have mentioned were all cases of receipts the precise amount of which had been ascertained, though after the end of the year to which they properly belonged. No doubt it is much easier to get a satisfactory method for dealing with such cases. In the present case the analogue would be to wait until each retiring payment was made and then to write it back in appropriate proportions over the years covering the whole period of service. But such a method, even if ideal, is not practical politics and we can, I think, put it out of our minds. There seems, therefore, to be no alternative between letting each payment fall upon the year in which it is made or adopting some scheme of current provision such as the Appellant contends for. It is clear, at any rate, from what I have quoted above that there is nothing improper in admitting valuations or estimates if by so doing a truer balance is arrived at between the receipts of a year and the cost of earning them or the expenses of a year and the fruits of incurring them. Such estimates were in fact directed by the Court of Appeal and by this House in *John Cronk & Sons, Ltd. v. Harrison*, 20 T.C. 612, and again by this House in *Absalom v. Talbot*, 26 T.C. 166: see, too, the judgment of Lord Greene, M.R., in *Johnson v. W. S. Try, Ltd.*, 27 T.C. 167, at page 182. The decision in the last-mentioned case is, I think, of value in illustrating the point that however desirable it may be to bring in a valuation or estimate in order to give a better balance to a year's accounts, it cannot be right to do so if the figure which is to be inserted,

"hedged round . . . with every kind of contingency and speculation".

is too uncertain to be fairly treated as a receipt. What is true of receipts is true of liabilities. In my opinion, it is that point which constitutes the real difficulty of the present case.

But there is no difficulty if we accept the main argument of the Crown. That argument is that, quite simply, there is a rule of law which forbids the introduction of any provision for future payments in or payments out, if the right to receive them or the liability to make them is in legal terms contingent at the closing of the relevant year. The rule, it seems, is absolute

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and must be adhered to whatever the current principles or practices of commercial accountancy may require as a method of ascertaining the year's profits. And this is the argument which hitherto has prevailed in the High Court and the Court of Appeal. Now, in my opinion, there is no such rule of law governing the ascertainment of annual profits. Where does it come from? Not from anything to be found in the Income Tax Acts, which, indeed, by the well-known rule limiting the exclusion of debts, show a different and, as I think, a more realistic approach to the problem. Not from any decided authority which is binding on your Lordships. On the contrary, there are two decisions of this House which negative the existence of any such rule of law.

In *Sun Insurance v. Clark*⁽¹⁾, the House had to deal with the ascertainment of the profits of a fire insurance business which had two special features: it was growing, and the practice was in some cases to take premiums covering a longer risk than one year. The gross receipts inevitably included payments received in respect of unexpired policies, of each of which it could truly be said that any liability under it was contingent on the future maturing of the risk—no fire, nothing to pay. Yet the decision of the House recognised that it was correct for the insurance company to ascertain its profits for each year by carrying forward a fixed percentage of the gross premium income of the year as a provision against unexpired risk. No doubt the carry-forward was treated as a receipt of the succeeding year and that year charged again with a new provision in respect of its new premiums. But the point is that the profit of each year was held to be correctly ascertained despite the inclusion of a provision for contingent liabilities. No doubt, too, this was insurance business. But insurance business does not live in a world of its own in Income Tax law. What it does is to throw up in an accentuated form some of the problems that affect, though perhaps in less degree, the ascertainment of the true profit of many other businesses, and in some cases special rules have to be evolved to deal with them. The other decision is *John Cronk & Sons, Ltd. v. Harrison*⁽²⁾. The trader in that case had acquired by his trading a contingent right to receive certain moneys deposited with a building society. It would be impossible to say of any one of these deposits in the year in which it was made that it represented a certain right for the trader to be paid any part of it in the future, for by the terms of the arrangement with the house purchaser default on his part might involve forfeiture or reduction of the trader's deposit. It was not money in the trader's hand, and, moreover, it might never be. Yet this House upheld the order of the Court of Appeal that the contingent rights ought to be brought in as receipts of the year in which they arose, though at a valuation (if feasible), not at their face value.

I am satisfied by these decisions that there is no such rule of law as is suggested. The answer to the question what can or cannot be admitted into the annual account is not provided by any exact analysis of the legal form of the relevant obligation. In this case, as in the *Sun Insurance* case, you get into a world of unreality if you try to solve your problem in that way, because, where you are dealing with a number of similar obligations that arise from trading, although it may be true to say of each separate one that it may never mature, it is the sum of the obligations that matters to the trader, and experience may show that, while each remains

⁽¹⁾ 6 T.C. 59.⁽²⁾ 20 T.C. 612.

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uncertain, the aggregate can be fixed with some precision. For the trader the practical question is always the same in these cases: How much more shall I have to pay out or shall I be able to get in than my current accounts of the year are recording? Legal analysis of the obligation may present it in a variety of different forms. There is the deferred payment which is subject to nothing more than the practical contingency that it may not be received. That is dealt with, as we know, by bringing it in at its face value, subject to allowance, or, in some cases, at a valuation. There is the future payment for work done which is only legally exigible if the whole work is completed. A large part of this particular aspect must be covered by such items of receipt as work-in-progress, but I do not know enough of the methods of valuing or allowing for this to speak with any confidence about it. And, lastly, there is the contingent obligation to make a future payment, which is our present case. But, whatever the legal analysis, I think that, for liabilities as for debts, their proper treatment in annual statements of profit depends not upon the legal form but upon the trader's answers to two separate questions. The first is: Have I adequately stated my profits for the year if I do not include some figure in respect of these obligations? The second is: Do the circumstances of the case, which include the techniques of established accounting practice, make it possible to supply a figure reliable enough for the purpose? The authorities *H. Ford & Co., Ltd. v. Commissioners of Inland Revenue*, 12 T.C. 997, *Peter Merchant, Ltd. v. Stedeford*, 30 T.C. 496, and *James Spencer & Co. v. Commissioners of Inland Revenue*, 32 T.C. 111, are no doubt very relevant in answering the second question, as must be the mere fact that an obligation is in its own terms contingent; but I regard them rather as illustrations of the kind of answer that should be given than as laying down any general principle or rule of law. Nor can I see what useful instruction is to be obtained from Lord Clyde's judgment in *Whimster & Co. v. Commissioners of Inland Revenue*, 12 T.C. 813. First, the learned Lord President's formulation of some general rules according to which annual profits should be determined for purposes of Income Tax is explicitly based on his understanding of what he calls "the correct principles of commercial accountancy". Secondly, his observation, no doubt correct, that annual profits properly determined are not to be treated as reduced by the circumstance that some part of them may be prudently reserved from distribution by the owner of the business to take care of an apprehended loss from future trading, offers no solution to the problem of the present case, in which the accountants who have given evidence would say, I suppose, that they were not advocating the making of a reserve but seeking to evaluate a current cost of working.

This brings me at last to the facts of the present case. I am bound to say that but for what has been found by the Special Commissioners I should have thought that the charges for retirement benefits which the Appellant has claimed to make in the four relevant years were well on the wrong side of what was permissible. When account is taken of all the circumstances I should have thought that the sums charged were a very long way from affording a scientific appraisal of the additional burden arising in respect of the year's services, and were, therefore, in the nature of a rough reserve against the future rather than a measured provision. Because what the Appellant has done is simply this. It has calculated what sum would be required to be paid to each employee in respect of retirement benefit if he retired without forfeiture at the close of the year, and the aggregate of what is required is set aside in so far

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as the year has contributed to the aggregate. I think that that is a sufficiently accurate description of the process as it was explained to us. But it seems to me to leave out of account several factors that are essential to the appraisal.

First, there is the contingency itself that any one benefit may in the end be forfeited. This seems to me the least important of the factors, since it is extremely probable that most will be paid; and on the fact found that the Appellant had never yet failed to pay retirement benefit to an employee on any ground, I think that the weight of the contingency is in effect nothing. But, secondly, it must not be forgotten that these benefits and their scale are imposed by legislation, not by voluntary contract, and one cannot exclude the possibility that both the form and the scale of what has to be paid may be altered again without the Company's consent. Thirdly, there is the very important factor of discount. To reserve each year's increment at face value, as the Appellant does, presents itself to me as making a serious over-provision. It is true that trade debts on short-term credit are not brought in at a discount; but here we are dealing with liabilities which cover a whole period of service and of which some may be deferred thirty or forty years before payment. No doubt each is at call at the close of the year, in the sense that any employee may retire and claim his accrued benefits on notice. But the point is that most of the staff would not be doing that; and to provide each year's increment at face value on the ground that it is in that sense presently payable seems to me to be falling into the same error, of confusing the individual legal form with the substance of the whole, which I find amiss with the argument for the Crown.

In my opinion, therefore, the Appellant must be wrong in omitting to allow for discounting. So much, indeed, was conceded by its Counsel in the course of argument. But then, it was said, that would be quite easy to do. I can see that it would be easy if the age of each workman and employee were known, the retirement age were fixed and each of them were to remain in service until that age. But then some will die and some will leave service before retiring age and these factors accelerate payment and so *pro tanto* increase the present value of each prospective payment. Well, it is said, given sufficient information, it will be possible to evaluate these factors by averages based on past experience and make adjustments of the discount accordingly. Perhaps it would, but the Case Stated gives us no information at all on the matter, and the averages themselves may be falsified by events, so leading either to over-provision or under-provision for the risks. If one is really going to formulate a watertight scheme of providing for such a difficult problem, I should expect to find that it included an arrangement for periodical revision of the aggregate of the outstanding appropriations in the light of the current risks, so that anything over-provided could be brought back into taxation.

Bearing these considerations in mind, I find it impossible to give any conclusive weight to the finding of the Special Commissioners that the Appellant's method of face value appropriations ought to be upheld, because

"it was a matter of correct accountancy practice in England to make provision in the accounts for the sums in question in the circumstances of this case."

I wish that I could, because I should view with dismay the assertion of legal theories as to the ascertainment of true annual profits which were in conflict with current accountancy practice and were not required by

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some special statutory provision of the Income Tax Acts. And it is apparent that in this case the Special Commissioners' finding was arrived at after hearing the evidence of the Company's auditor and another independent accountant of distinction. The auditor said, as auditors have said before in other cases, that he

"would not have signed the balance sheet without a qualification unless the afore-mentioned provision had been made".

All this is very important, because, of course, accountants are very specially concerned with the problems that attend the true ascertainment of a year's profit and the establishment of techniques that assist in this. But, for all that, there is nothing in the Case that seems to me to fix on the point that is really the heart of this appeal. The requirements that an auditor may make before signing a balance sheet (I assume that the words used in the Case are meant to cover the statutory reference to the profit and loss account) do, no doubt, cover his opinion that that account gives a "true and fair view" of the profit for the financial year, but I do not think that such requirements are necessarily the same thing as the auditor's opinion that some particular provision could not be omitted without compromising the true and fair view. It is not possible completely to equate the balance shown by a company's profit and loss account with the balance of profit arising from the trade for the year. The word "provision" is becoming a technical one in contradistinction to the word "reserve" owing to the definitions of the two terms supplied by the Companies Act, 1948, Eighth Schedule, Part IV, Paragraph 27; but the word "provision" includes any amount written off or retained

"for any known liability of which the amount cannot be determined with substantial accuracy",

and I think that one is bound to say that references to an auditor's duty under the Companies Act take us into a field that is not exactly the same as that in which the annual profits of trade should be ascertained for the purposes of Income Tax. There is nothing in the evidence or the Special Commissioners' finding which supplies an answer to what I regard as the vital question relevant to these cases: Is the sum provided an essential charge against the receipts of the trade in order to enable a true profit from that source to be stated for the year in question? And, as I see it, such a question cannot be answered just by one man's opinion. It is important to know how far it is supported by accepted theory or established practice. In the absence of any light on all these points, I think that your Lordships are bound to use your own judgment, supported, indeed, as it is, by the admissions made by the Appellant's Counsel during the course of the hearing and by the fact that an alternative, albeit a rough and ready, method is available which has, after all, been adopted in the past.

My Lords, I feel bound to come to the conclusion that the appeal fails. I do not think that this is an occasion upon which the case should be remitted to the Special Commissioners to see whether a new and more satisfactory method of provision could be extracted from evidence. The Appellant has stood throughout on its claim that the provisions that were claimed before the Special Commissioners were those that it was entitled to make, though I gather that during the course of the various appeals it was admitted that it might be proper to discount. To send the case back, when it is not even certain that a proper method can be found, is really to start it all over again and would apparently involve the hearing of further evidence. That is to go beyond the function of a final appeal.

Lord Tucker.—My Lords, I have had the advantage of reading in print the opinion of my noble and learned friend, Lord Radcliffe, which has just been delivered. I agree with him that there is no such absolute rule of law governing the ascertainment of annual profits as was contended for by the Crown in the present case, and that there is no ground for holding that the decision of this House in *Sun Insurance Office v. Clark*, 6 T.C. 59, must be confined exclusively to insurance companies. I also agree, for the reasons which he has given, that the finding of the Special Commissioners that the Appellant's method of accounting is in accordance with correct accountancy practice cannot, in the circumstances of this case, be regarded as conclusive.

I would accordingly dismiss the appeal.

Questions put :

That the Order of the Court of Appeal be reversed.

The Not Contents have it.

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

The Contents have it.

[Solicitors:—Solicitor of Inland Revenue ; Smiles & Co.]
