HIGH COURT OF JUSTICE (CHANCERY DIVISION)—
26TH, 27TH and 28TH JULY, 1961

COURT OF APPEAL—9TH, 12TH AND 13TH MARCH, 1962

HOUSE OF LORDS—
11TH, 12TH AND 13TH MARCH, AND 10TH APRIL, 1963

Rae (H.M. Inspector of Taxes)

v.

Lazard Investment Co., Ltd.[1]

Income Tax, Schedule D, Case V—*Capital or Income—Distribution of assets of foreign company.*

The Respondent Company, a United Kingdom investment holding company, owned 2,000 $1 *shares in an American company, C, which manufactured and sold asphalt roofing products and also gypsum and paper products. In* 1956 *C transferred the latter part of its business to a newly formed American company, B, in exchange for shares which C then distributed among its shareholders, including the Respondent Company. This distribution was effected under the law of the State of Maryland by a "distribution on partial liquidation" without any reduction in C's stated capital.*

On appeal to the Special Commissioners against an assessment to Income Tax under Case V *of Schedule D for the year* 1956–57 *in respect of shares received in the distribution, the Company contended that the distribution, having been impressed by C with the quality of a return of capital under the law of Maryland, was capital for all purposes and was not assessable as income under Case* V *of Schedule D. The Special Commissioners upheld the Company's contention and discharged the assessment.*

Held, *that the Commissioners' decision was correct.*

Commissioners of Inland Revenue *v.* Reid's Trustees, 30 T.C. 431, *distinguished.*

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 High Court of Justice.

I. At a meeting of the Commissioners for the Special Purposes of the Income Tax Acts held on 13th and 14th October, 1959, Lazard Investment

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(1) Reported (C.A.) 106 S.J. 242; (H.L.) [1963] 1 W.L.R. 555; 107 S.J. 474.

Co., Ltd., appealed against an Income Tax assessment in the sum of £12,507 for the year 1956–57 under Case V of Schedule D in respect of a distribution of certain shares received by it in the circumstances set forth hereafter in this Case.

II. A statement of agreed facts was handed to us and reads as follows :

(1) Lazard Investment Co., Ltd. (hereinafter called " Lico "), was incorporated in England under the Joint Stock Companies' Acts, 1856 and 1857, and the Companies Act, 1948. Lico carries on business (*inter alia*) as an investment holding company, and for the purposes of United Kingdom Income Tax submits claims for repayment of Income Tax on its management expenses under Section 425, Income Tax Act, 1952. It is assessable under Case V of Schedule D in respect of income from foreign possessions ; it is not assessable under Case I of Schedule D as a dealer in shares.

(2) In June, 1955, Lico purchased for investment 2,000 common shares of the par value of $1 each in Certain-teed Products Corporation (hereinafter called " Certain-teed "), a company incorporated in 1917 under the laws of the State of Maryland, U.S.A. Prints of Certain-teed's certificate of incorporation and its by-laws, as adopted on 18th November, 1946, and amended up to 14th May, 1958, are attached (see paragraph III of this Case). The cost of the 2,000 common shares in Certain-teed purchased by Lico amounted to £21,397 14*s.* 3*d.*

(3) Since its incorporation Certain-teed has been continuously engaged in the manufacture and sale of asphalt roofing products. For upwards of 30 years to 1st July, 1956, it had also been engaged in the manufacture and sale of gypsum and paper products. These dual activities carried on by Certain-teed in substance constituted separate and distinct businesses, and in 1956 the board of directors of Certain-teed decided for a number of reasons that the time had arrived to carry through a scheme of reorganisation whereby the gypsum and paper activities should be " hived off " into a separate corporation. In particular, the gypsum and paper undertaking required a substantial amount of additional capital in order to develop and expand its operations to the best advantage, and it was considered by the directors of Certain-teed that this additional capital could be more readily obtained by a corporation solely engaged in the gypsum and paper business. Notwithstanding that more than 40 per cent. of its sales were derived from its gypsum and paper products, Certain-teed was regarded by financial and investment circles in the U.S.A. primarily as an asphalt roofing company ; and this fact militated against the raising of new capital on as favourable terms as a company engaged solely in the manufacture and sale of gypsum, which had come to be regarded as a " growth " business. In view of this, and because of the many differences between the asphalt roofing and gypsum businesses, it appeared that separate incorporation and ownership of the two businesses would be beneficial to Certain-teed and its stockholders.

(4) The form of reorganisation which, on legal advice, the board of Certain-teed decided to adopt, subject to the approval of its stockholders, entailed a " distribution in partial liquidation " within the meaning of Article 23, Section 70, of the Corporation law of the State of Maryland. (The relevant Article governing the procedure is reproduced in Paragraph III of this Case.)

(5) A new company, Bestwall Gypsum Co. (hereinafter called "Bestwall"), was incorporated under the law of Maryland for the purpose of acquiring from Certain-teed the net assets of its gypsum and paper undertaking. Certain-teed and Bestwall entered into an agreement dated as of 14th May, 1956, pursuant to which Bestwall agreed to deliver to Certain-teed, or upon its order, 715,145 common shares of the par value of $1 each (which was to be the whole of its issued capital stock), in consideration for which Certain-teed agreed to transfer to Bestwall the net assets pertaining to its gypsum and paper undertaking. The agreement included provisions relating to the separation of the two businesses with effect from 1st July, 1956, such separation being dependent upon the approval, at a special meeting to be convened of the common stockholders of Certain-teed, of the distribution to them of the common shares of Bestwall. (The said agreement, called document "C", is referred to in paragraph III of this Case.)

(6) Certain-teed accordingly convened a special meeting of its common stockholders on 31st July, 1956, for the purpose of considering and voting upon (*inter alia*) the distribution of all the issued common shares of Bestwall to the holders of Certain-teed's common stock, the basis of distribution being one common share of Bestwall for each three shares of Certain-teed's common stock.

(7) The distribution was duly approved by the appropriate majority of the holders of the common stock of Certain-teed pursuant to the requirements of Article 23, Section 70(*b*)(3), above-mentioned, and with effect from 1st July, 1956, Bestwall took over and has since carried on the gypsum and paper business operated by Certain-teed up to that date. (A copy of the resolution passed by the stockholders of Certain-teed, called document "D", is referred to in paragraph III of this Case.)

(8) Full details of the scheme of reorganisation are given in the letter dated 21st June, 1956, issued to the common stockholders of Certain-teed under the signature of its chairman, Mr. Rawson G. Lizars, and in the proxy statement accompanying the notice convening the special meeting of stockholders on 31st July, 1956, which are included in the documents as "E" and "F" respectively (see paragraph III of this Case.)

(9) There are attached to the proxy statement (document "F") a number of financial statements, and on pages 12 and 13 there will be found a statement entitled "Consolidated and Pro forma Consolidated Balance Sheets as at 31st December, 1955". There are also annexed (to this Case) the annual reports and accounts of Certain-teed and Bestwall as at 31st December, 1956 (documents "G" and "H" respectively—see paragraph III of this Case.)

(10) Prior to the convening of the special meeting of its common stockholders, Certain-teed had asked for and received a ruling from the United States Internal Revenue Department that the distribution of the Bestwall shares would not be regarded as income to the holders of the common stock of Certain-teed for the purposes of the U.S.A. Federal Income Tax. This ruling was given in a letter dated 13th June, 1956, written on behalf of the Commissioner of Internal Revenue (called document "I"—see paragraph III of this Case) and is referred to on page 2 of the proxy statement in the paragraph headed "Tax Consequences". The ruling further stated that for the purposes of U.S. Capital Gains Tax the cost or other basis adopted by a stockholder for his holding of shares in Certain-teed would be allocated between the Certain-teed and the Bestwall stock in the proportion of the relative fair market values of the two stocks at the date of

distribution of the Bestwall shares, and that a stockholder would be considered to have held the Bestwall shares received by him from the date he acquired his holding of shares in Certain-teed.

(11) After the scheme of reorganisation had been approved by the requisite majority at the special meeting held on 31st July, 1956, the 715,145 shares of Bestwall were distributed to the Certain-teed stockholders on record at 7th August, 1956, and the certificates for the Bestwall shares were delivered on 22nd August, 1956. By virtue of its holding of 2,000 common shares of Certain-teed, Lico received 666⅔ Bestwall shares.

(12) On the New York Stock Exchange the Certain-teed common stock was first dealt in "ex-Bestwall" on 2nd August, 1956. On the relevant dates dealings were recorded within the following price ranges:

1st August, 1956, Certain-teed shares cum Bestwall, $33⅞–$35¼.

2nd August, 1956, Certain-teed shares ex Bestwall, $12–$13⅜.

An advice note dated 22nd August, 1956, was received, confirming that the certificates for the Bestwall shares had been delivered as of 21st August, 1956. On this date the Certain-teed shares closed at $13¾ and the Bestwall shares closed at $74.

(13) At a meeting of the board of directors of Lico held on 18th September, 1956, the following resolution was passed:

> "The Company having been advised on 13th August that in respect of its holding of 2,000 Certain-teed common shares it had been allotted 666⅔ Bestwall common shares, free of cost, and the respective values of the two shares immediately after the operation having been approximately $13¾ and $74, it was decided that the original cost of the Certain-teed shares, viz.:— £21,397 14s. 3d., should be divided in the ratio 41:74 so that the book cost of the two investments now held would be shown as:—

		£	s.	d.
2,000 Certain-teed Products Common	Cost	7,628	14	3
666⅔ Bestwall Gypsum Common	Cost	13,769	0	0
		£21,397	14	3"

No credit was taken for the value of the Bestwall shares in Lico's profit and loss account, the only book entries being in the investment accounts arising out of the apportionment of the original cost of the Certain-teed holding, as mentioned above.

(14) On 26th November, 1957, H.M. Inspector of Taxes raised an assessment on Lico under Schedule D, Case V, for the year 1956–57, in the sum of £12,507 in respect of the Bestwall shares which it received in the circumstances set out above. The amount of this assessment was based on a value of $50 per share stated on page 8 of the proxy statement (document "F") to have been fixed by the board of Bestwall as their fair market value plus a dollar premium of 4½ per cent. on $2·78½. On 5th December, 1957, Lico gave notice of appeal against this assessment on the grounds that it was erroneous in law.

III. The following documents were admitted, and are attached to and form part of this Case[1]:

A. (i) Certain-teed Products Corporation: certificate of incorporation.

(ii) Certain-teed Products Corporation: by-laws.

B. Extract of Article 23, Section 70, Maryland Corporation law.

C. Separation agreement between Certain-teed and Bestwall.

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[1] Not included in the present print.

D. Certain-teed, minute of meeting of stockholders, 31st July, 1956.

E. Letter of 21st June, 1956, to stockholders of Certain-teed.

F. Notice of special meeting and proxy statement.

G. Certain-teed ; annual report, 1956.

H. Bestwall ; annual report, 1956.

I. Letter of 13th June, 1956, Commissioners of Internal Revenue to Mr. Leo J. Schwartz.

J. Extract of Article 75B, Annotated Code of Maryland.

In view of its importance in considering this Case, we reproduce Exhibit " B ", which states as follows:

" EXTRACT FROM MARYLAND CORPORATION LAW
ARTICLE 23, SECTION 70

Partial Liquidation and Reorganisation

1951, ch. 135

70 (Distributions in Partial Liquidation.) (*a*) If authorised in the manner provided in subsection (*b*) of this section, any corporation of this State may, from time to time, declare a partial liquidating distribution to stockholders and in payment thereof may distribute a portion of its assets in cash or property, subject to the following restrictions:

(1) No such distribution shall be declared or made at a time when the corporation is insolvent or when the payment of such distribution would render the corporation insolvent. For the purposes of this section, a corporation shall be deemed to be insolvent if its debts exceed its assets taken at a fair valuation or if it is unable to meet its debts as they mature in the usual course of business.

(2) No such distribution shall be declared or made to any class of stockholders until all accumulated dividends on classes of shares entitled to cumulative preferential dividends have been fully paid or provided for, unless the distribution is made to the holders of shares having preferential rights in the order and to the extent of their respective priorities.

(3) No such distribution shall be declared or made to any class of stockholders, the payment of which would reduce the remaining net assets below the aggregate preferential amount payable in the event of voluntary liquidation to the holders of shares having preferential rights, unless the distribution is made to the holders of shares having preferential rights in the order and to the extent of their respective priorities.

(4) No such distribution shall be declared or made when the stated capital is impaired or when the payment thereof would impair the stated capital of the corporation, but subject to the limitations imposed by this section, such distributions may be declared and made out of surplus, including surplus arising from a reduction in the amount of the stated capital made pursuant to the provisions of this Article.

(5) Each such distribution, when made, shall be identified as a liquidating distribution and the amount per share as determined from the books of the corporation shall be disclosed to the stockholders receiving the same prior to or concurrently with the payment thereof.

(*b*) Every distribution in partial liquidation by any corporation of this State shall be made in the manner authorized by the charter or, in the absence of any charter provision relating thereto, in the manner following:

(1) The Board of directors shall adopt a resolution declaring that the liquidating distribution is advisable and directing that the proposal be submitted for action thereon at either an annual or a special meeting of stockholders.

(2) Notice stating that a purpose of the meeting will be to take action on the proposed distribution shall be given, as required by this Article, to all stockholders entitled to vote thereon.

(3) The proposed distribution shall be authorized by the stockholders by the affirmative vote of two-thirds of all the votes entitled to be cast thereon

or, if two or more classes of stock are entitled to vote separately thereon, then by two-thirds of each class.

(c) If the liquidating distribution is to be made in property, the value of such property, together with the value of the distribution per share, shall be stated by the directors."

IV. The two sides had been unable to agree on one matter, namely, the quality of the distribution received by Lico, having regard to the law of the State of Maryland. On that matter, evidence was given before us by Mr. McKenny White Egerton, who is a partner in the firm of Piper & Marbury of Baltimore, Maryland, U.S.A. We found the following facts from Mr. Egerton's evidence:

(1) Mr. Egerton, who is a member of the Maryland Bar, has always specialised in the field of corporation law, and for the past 25 years he has edited periodical compilations of annotated Maryland Statutes dealing with corporation law published by the Tax Commission of the State of Maryland. In 1947 he was appointed a member of a State Commission to make a comprehensive study of Maryland corporation law and to submit a revised code. The revised code submitted by the Commission in 1951 was based substantially on a model Act prepared by the United States Bar Association shortly after the end of the 1939–45 War. That Association had endevoured to set a pattern of unity in all the States. The revised code was given the force of law in Maryland in 1951. The provisions in Section 70 of Article 23 (Exhibit " B ", which is reproduced at the end of Paragraph III of this Case) were taken verbatim from the model Act. Prior to 1951 there was no provision in Maryland corporation law dealing with partial liquidation. Indeed, in 1947 the concept of partial liquidation was a novel one and had been embodied in the law of only a few States.

(2) Mr. Egerton had been consulted by the General Counsel of Certain-teed on matters of corporation law over a very long period. In 1956 he was asked what Corporation action would be required in order to " hive-off " part of Certain-teed's activities into a separate corporation. In particular he was asked whether it could be done by action of the board of directors alone, or whether it was a matter that required action by the stockholders. Mr. Egerton advised Certain-teed that the proposed " hive-off " would constitute a partial liquidation, which would require action initially by the board of directors declaring it advisable and subsequently by the stockholders giving it approval under the said Section 70.

(3) Certain-teed effected the " hive-off " by proceeding under the said Section 70. Certain-teed did not declare a dividend: under Maryland law it would not have been possible to effect this " hive-off " by way of a declaration of dividend. What the stockholders received from Certain-teed was part of Certain-teed's capital assets, represented by stock in Bestwall. Put in another way, the distribution effected a division of capital assets formerly owned by Certain-teed and now owned in part by Certain-teed and in part by Bestwall.

(4) In the case of a distribution under the said Section 70 to a stockholder who held Certain-teed stock as a trustee for a Maryland trust, the question as to whether the distribution is to be regarded as principal or income of the trust is answered by Section 3(2) of Article 75B (Exhibit " J "). The relevant words are

" All receipts . . . in liquidation of the assets of a corporation ".

Under Article 75B the Bestwall stock would belong to " remainder-men " and not to " tenants " (as defined in Section 1 of Article

75B). The said Article 75B was copied by the State of Maryland from one of the model Acts promulgated by the Commissioners on Uniform State Laws; most of the States of the Union have adopted a similar provision. The words "in liquidation" in the said Section 3(2) cover a partial liquidation as well as a full liquidation.

(5) The observation of Lord Normand in *Commissioners of Inland Revenue* v. *Reid's Trustees,* 30 T.C. 431, at page 442, viz.:

> "it is incorrect, both in law and in substance, though I would prefer to draw no such distinction, to treat the shareholders as possessing the capital assets of the company",

would be a correct statement of the law in Maryland.

(6) As a result of the distribution by Certain-teed in partial liquidation, under Maryland law Lico's original interest in Certain-teed did not remain intact. Under that law the Courts of Maryland would look for the substance of the transaction. The substance of this transaction was that Lico's original interest was in the entirety of Certain-teed's capital assets; Lico's subsequent interest was compromised in its combined holdings of stock in Certain-teed and in Bestwall, and those two holdings represented in reality the identical assets in which it had its original interest. Without any question, under the law of Maryland Lico did not receive a dividend from Certain-teed, but received capital.

V. It was contended on behalf of Lico that the distribution of shares (or stock), having been impressed by Certain-teed with the quality of a return of capital and being a return of capital under the law of Maryland, was capital for all purposes including United Kingdom Income Tax purposes, and therefore could not be income assessable under Case V of Schedule D; and that accordingly the appeal should succeed.

VI. It was contended on behalf of H.M. Inspector of Taxes:

(*a*) that notwithstanding the evidence as to the nature of the distribution made by Certain-teed under the law of Maryland, the share capital of the distributing corporation remained unimpaired and Lico's shareholding in that corporation remained "intact" within the meaning of that word as used by Lord Simonds in *Commissioners of Inland Revenue* v. *Reid's Trustees,* 30 T.C. 431, at page 440;

(*b*) that Lico's shareholding in Certain-teed was a foreign possession, and, as this remained intact, the distribution of shares in Bestwall received in respect of it was income from a foreign possession taxable under Case V of Schedule D; and

(*c*) that, accordingly, the appeal should fail.

VII. We took time to consider our decision, which we gave in writing on 22nd October, 1959, as follows:

From the documents produced and the oral evidence given before us we have found as facts:

(*a*) Certain-teed did not declare a dividend;

(*b*) the distribution to Certain-teed's shareholders was made within the terms of Section 70 of the law relating to corporations in the State of Maryland;

(*c*) in the circumstances of the present case the distribution to the shareholders could not, under the law of the State of Maryland, have been made as a dividend.

We have to decide whether the distribution received by Lico, a United Kingdom shareholder, is assessable on the recipient under Case V of Schedule D as income from a foreign possession. What Lico enjoys is the ownership of shares in a corporation in the State of Maryland, not the ownership of shares in a company constituted in the United Kingdom. In our view of the matter, Lico's interest in Certain-teed depends upon the law of the State of Maryland, and, in our opinion, when a distribution in partial liquidation is made under that law it cannot be said that the original shareholding remains unaltered.

A "partial liquidating distribution" is a conception which, so far as we are aware, is unknown in the company laws of the United Kingdom, and the authorities to which we were referred do not, of course, deal with such a distribution. As we understand the authorities, the question which falls to be determined by us in this case is whether the said distribution is income flowing from Lico's shareholding in Certain-teed or whether it is a capital distribution which altered Lico's rights in Certain-teed.

We are of opinion, and so hold, that the "partial liquidating distribution" received by Lico was not income arising from Lico's shareholding in Certain-teed, but was a distribution of capital made in accordance with powers conferred by the relevant company law. Such a distribution must, in our view, be regarded as diminishing the rights previously held by Lico in Certain-teed.

Accordingly, the appeal succeeds. We leave figures to be agreed.

VIII. In due course it was reported to us that figures had been agreed, and on 4th March, 1960, we determined the appeal by discharging the assessment.

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

IX. The question for the opinion of the High Court is whether our decision in paragraph VII of this Case was correct in law.

F. Gilbert } Commissioners for the
W. F. Bradley } Special Purposes of the Income Tax Acts.

W. F. Gilbert } Commissioners for the
W. E. Bradley } Special Purposes of the Income Tax Acts.

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

6th December, 1960.

The case came before Plowman, J., in the Chancery Division on 26th, 27th and 28th July, 1961, when judgment was given in favour of the Crown, with costs.

Mr. John Foster, Q.C., Mr. E. B. Stamp and Mr. Alan Orr appeared as Counsel for the Crown, and Mr. Philip Shelbourne and Mr. R. Holroyd Pearce for the Company.

Plowman, J.—This is an appeal by the Crown against a decision of the Special Commissioners discharging an Income Tax assessment on the Respondent Company, which I will call "Lico", in the sum of £12,507 for the year 1956–57 under Case V of Schedule D. The assessment was made in respect of a distribution of certain shares in a company called Bestwall Gypsum Co. received by Lico in respect of its holding in another company called Certain-teed Products Corporation. I will refer to the former company as "Bestwall" and to the latter as "Certain". Both were American companies incorporated under the laws of the State of Maryland.

Lico is an English company which carries on business, *inter alia*, as an investment holding company. In 1955 it purchased for investment 2,000 $1 shares in Certain. The principal business of Certain was the manufacture and sale of asphalt roofing products, but up to July, 1956, it was also engaged in the manufacture and sale of gypsum and paper products. In 1956 the board of Certain decided to "hive-off" the gypsum and paper side of its business to a separate corporation, and to this end Bestwall was incorporated. The assets representing Certain's gypsum and paper business were then transferred to Bestwall in exchange for 715,145 $1 shares in Bestwall, which constituted the whole of its issued capital. Certain then resolved to distribute these Bestwall shares among its own shareholders, the basis of the distribution being one share of Bestwall for each three shares of Certain. As a result of this distribution, in August, 1956, Lico received 666⅔ Bestwall shares in respect of its holding of 2,000 shares in Certain. This distribution was effected by means of what, in the State of Maryland, is called "a distribution in partial liquidation".

The relevant statutory provision under which this transaction was carried out is the Maryland Corporation law, Article 23, Section 70. So far as material, the provisions of this Section are as follows:

> "70 . . . (a) . . . any corporation of this State may, from time to time, declare a partial liquidating distribution to stockholders and in payment thereof may distribute a portion of its assets in cash or property, subject to the following restrictions: . . . . (4) No such distribution shall be declared or made when the stated capital is impaired or when the payment thereof would impair the stated capital of the corporation, but subject to the limitations imposed by this section, such distributions may be declared and made out of surplus, including surplus arising from a reduction in the amount of the stated capital made pursuant to the provisions of this Article."

It will be noted, first, that the subject-matter of a distribution in partial liquidation is: "a portion of its assets in cash or property"; and, secondly, that a distribution can only be made in circumstances which leave the capital of the distributing corporation unimpaired unless it is made on a reduction of capital pursuant to the provisions of Article 23. I take that to refer to some other Section of Article 23, because there is nothing about it in Section 70. Moreover, it has not been suggested in this case that the distrition with which I am concerned was made on a formal reduction of capital.

The question which I have to decide is whether the 666⅔ shares in Bestwall which Lico received were, to quote the wording of Case V of Schedule D, "income arising from possessions out of the United Kingdom". The Special Commissioners heard evidence as to the law of Maryland, and on that evidence found the following, among other facts. I refer to the Case Stated, paragraph IV (3), where it is said:

> "Certain-teed effected the 'hive-off' by proceeding under the said Section 70. Certain-teed did not declare a dividend: under Maryland law it would not have been possible to effect this 'hive-off' by way of a declaration of dividend. What the stockholders received from Certain-teed was part of Certain-teed's capital

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> assets, represented by stock in Bestwall. Put in another way, the distribution effected a division of capital assets formerly owned by Certain-teed and now owned in part by Certain-teed and in part by Bestwall."

Then, in sub-paragraph (6) of the same paragraph, this is said:

> "As a result of the distribution by Certain-teed in partial liquidation, under Maryland law Lico's original interest in Certain-teed did not remain intact. Under that law the courts of Maryland would look for the substance of the transaction. The substance of this transaction was that Lico's original interest was in the entirety of Certain-teed's capital assets; Lico's subsequent interest was comprised in its combined holdings of stock in Certain-teed and in Bestwall, and those two holdings represented in reality the identical assets in which it had its original interest. Without any question, under the law of Maryland Lico did not receive a dividend from Certain-teed, but received capital."

Then, in paragraph VII of the Case Stated, the following passage occurs in the decision of the Special Commissioners:

> "In our view of the matter, Lico's interest in Certain-teed depends upon the law of the State of Maryland, and, in our opinion, when a distribution in partial liquidation is made under that law it cannot be said that the original shareholding remains unaltered. A 'partial liquidating distribution' is a conception which, so far as we are aware, is unknown in the company laws of the United Kingdom, and the authorities to which we were referrd do not, of course, deal with such a distribution. As we understand the authorities, the question which falls to be determined by us in this case is whether the said distribution is income flowing from Lico's shareholding in Certain-teed or whether it is a capital distribution which altered Lico's rights in Certain-teed. We are of opinion, and so hold, that the 'partial liquidating distribution' received by Lico was not income arising from Lico's shareholding in Certain-teed, but was a distribution of capital made in accordance with powers conferred by the relevant company law. Such a distribution must, in our view, be regarded as diminishing the rights previously held by Lico in Certain-teed."

The Crown submit that in these circumstances the case is governed by the decision of the House of Lords in *Commissioners of Inland Revenue* v. *Reid's Trustees,* 30 T.C. 431. The headnote of that case is as follows:

> "The Respondent Trustees held shares in a South African trading company. The company sold certain warehouses and office premises, which it occupied for the purposes of its trade, at a profit out of which it declared and paid a dividend of 20 per cent. 'payable from capital profits'. The dividend was received by the Trustees without deduction of Income Tax, and the dividend on shares held for liferenters of the trust was credited by the Trustees to the revenue accounts of the liferenters. On an appeal of the Special Commissioners against an assessment to Income Tax under Case V of Schedule D in respect of the dividend, the Trustees contended that the dividend, having been paid out of profits of a capital nature, was not assessable to Income Tax. The Special Commissioners upheld the Trustees' contention, and discharged the assessment. *Held,* that the dividend received by the Trustees was income arising from foreign possessions assessable to tax under Case V of Schedule D."

That, I think, sufficiently states the facts.

As regards the facts, Mr. Shelbourne, for Lico, points out that what was paid in that case was admittedly a dividend. In the present case, he submits, the distribution was not the payment of a dividend but a distribution of capital. He says that one must look to the provenance of what the shareholder receives and if, so viewed, it is truly capital, then there is nothing in *Reid's* case to make it taxable: as capital, it is outside Case V. Mr. Foster, for the Crown, points out that the distribution or dividend in *Reid's* case was in fact a distribution of capital assets, and that therefore the problem cannot be resolved merely by inquiring whether the distribution was a dividend paid out of income or a capital profits dividend. He agrees, however, with Mr. Shelbourne to this extent, that a return of capital to a shareholder on a

reduction of capital would not be income in his hands for the purposes of Case V.

I turn now to the speeches in the *Reid* case(1). Lord Simonds, at page 439, said this:

> "The claim of the [Crown] is founded on Case V of Schedule D. They say that this sum of £6,866 is 'income arising from possessions out of the United Kingdom', that the shares in a South African company are possessions out of the United Kingdom, and that the sum in question is income arising from those shares. They say that there is no *tertium quid*. This sum is either capital or income. How can it be capital if the shares remain intact, so many shares of £10 each in the capital of the company? There is a way of distributing a dividend while leaving the capital intact, and there is a way of returning part of the capital: it is the former course that has here been taken. This then, they say, is income."

I pause there to say that when Lord Simonds refers to "a way of returning part of the captial" he is, I think, clearly referring to a reduction of capital. Then, a little later on the same page(2), Lord Simonds continues:

> "My Lords, this is the short and simple case made by the [Crown] and I see no answer to it. The learned Lord President (Cooper) accepted an answer which he thus stated(3): 'The short answer of the Respondents, accepted by the Special Commissioners after investigating the facts, is that this sum is not the income of anyone, and never was. I agree.' My Lords, I must say, with great respect that I think that this conclusion can only be reached by ignoring that what may be regarded as capital in the hands of the payer may yet be income in the hands of the payee. It is begging the question to say that this sum is not income in the hands of the shareholders; by every practical test it has proved to be income. I will assume that the money out of which the dividend was paid was capital in the hands of the company for the purpose at any rate of ascertaining its taxable profits. I think that the Commissioners were entitled to find that as a fact; but it was not the fact, and they were not entitled to find as a fact, that the dividend in the hands of a recipient shareholder was not his income."

Then, at page 440, Lord Simonds said:

> "It is not, I think, going too far to say that for the determination of the question, whether under Case V the dividend payable upon the shares of a foreign company is taxable income, it is irrelevant and, more than that, misleading to look to the analogy of an English company. And here, too, I would remind your Lordships of the observation of Lord Phillimore in *Bradbury* v. *English Sewing Cotton Co., Ltd.*(4), [1923] A.C. 744, at page 770, that, in regard to the income arising from foreign possessions, 'The officers of the Crown do not know and do not care what is the character of the sources from which the money comes.' I must not be taken as suggesting any inaccuracy or insufficiency in the information which has in this case been furnished by the South African company, but it is obvious that, as a general rule, the Inland Revenue authorities cannot have the same facilities for investigating the affairs of a foreign company and checking its statement that a dividend is paid out of 'capital profits'. They must work upon a broader basis, and I cannot imagine a safer or better one, where the question is as to income arising from a foreign possession, than to ask whether the corpus of the asset remains intact in the hands of the taxpayer. That question can, in the case of the shares here in question, only be answered in the affirmative. The shares the Respondents held before the distribution of dividend they still hold intact. The dividend they received was income arising out of those shares."

Then I cite a short passage from the speech of Lord Normand, at page 442, where he said:

> "In law capital cannot be returned to shareholders by a mere money distribution whether called a dividend or by some other name, and there was in this instance no return of capital. The shares of the company remained after the distribution intact and precisely as they were before it. The payment wears on the face of it, therefore, the appearance of an income receipt in the hands of the shareholders."

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(1) 30 T.C., at p. 431. (2) *Ibid.*, at p. 439. (3) *Ibid.*, at p. 437. (4) 8 T.C. 481, at p. 519.

(Plowman, J.)

Then, Lord Morton of Henryton said this, at page 445[1] :

> " Was this sum of £6,866 received by the Respondents on 14th December, 1943, income arising from a possession out of the United Kingdom within Case V? If the Respondents had owned the four properties in Johannesburg, which were sold in March, 1943, and if their agents in South Africa had remitted part of the proceeds of sale to the Respondents, there would be no doubt that these moneys would form part of the capital of the trust and would not come within Case V. In that event the Respondents would merely have transformed one form of capital, the four properties, into another form of capital, cash, which would have to be invested as part of the trust capital. The Respondents did not, however, own these four properties. They were owned by a different entity, namely the company. The trustees owned the 3,433 shares, and the ' possession ' from which the sum of £6,866 ' arose ' was the shares. This sum must be either income arising from that possession or part of the capital of that possession. Despite the ingenious argument of Counsel for the Respondents, I am clearly of opinion that it cannot be part of the capital of that possession. No part of that possession has been sold ; no part of the capital paid up on that possession has been returned. Before the payment was made the Respondents held 3,433 shares of £10 each fully paid in the company ; after the payment was made their holding was exactly the same. All that happened was that certain cash belonging to the company, and representing part of the profit realised by the sale of a capital asset belonging to the company, was paid away as a dividend."

Then, Lord Reid said, at page 449[1] :

> " The crucial question in this case must, therefore, be decided with little direct assistance from authority. The contention for the Inland Revenue has the merit of extreme simplicity, if that be a merit in questions of Income Tax. It is that the dividend cannot be capital because the Respondents' foreign possessions, the shares, remain intact and, therefore, the dividend must be income. It is admitted that if the money had been paid by way of reduction of the share capital, that would not have been income ; the shares would not have remained the same. It is also admitted that if the surplus profits had been used to create bonus shares, or even it may be bonus debentures, there would have been no receipt of income ; new capital assets would have been created. But it is said that, so long as the capital asset abroad remains the same, anything received by the shareholder in this country must be income subject to assessment under Case V of Schedule D. This may seem a technical argument which neglects the real fact that the capital value of the Respondents' foreign asset has been reduced by the making of the payment. But a company can, and often does, reduce considerably the market value of its shares by paying a dividend out of accumulated trading profits, and there can be no doubt that such a dividend would fall within Case V, if it came from a foreign company. There are many ways in which a company can deal with its profits. If it adopts certain methods the result is the creation of new capital assets. If it adopts other methods the result is the receipt of income by its shareholders. In either case it is immaterial whether the profits were trading profits or capital profits. It is true that, owing to the special provisions of the Income Tax Acts which distribute liability for Income Tax (including Sur-tax) between a British company and its shareholders, a dividend paid by a British company out of its capital profits is not taxable. But there are no provisions applicable to a foreign company which bring about this result."

In my judgment, there was no reduction of capital in the present case. As I have already said, it is not suggested that there was any formal reduction under Article 23 ; and the fact that, under Section 70, it was a condition precedent to a distribution in partial liquidation that Certain's capital should remain unimpaired is inconsistent with the view that any reduction of capital took place. *Prima facie,* therefore, one simply has to ask oneself the question posed by Lord Simonds : Does the corpus of the foreign possession remain intact in the hands of Lico? The answer to that question is undoubtedly " Yes ", in the sense that, both before the distribution and afterwards, Lico held 2,000 $1 shares in Certain, although no doubt depreciated in value as a result of the distribution of part of Certain's capital assets.

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(1) 30 T.C.

(Plowman, J.)

Mr. Shelbourne, however, submits that, in addition to the cases of a return of capital to a shareholder on a reduction of capital or on a winding-up of a company, there may be other cases in which a distribution made by a foreign company is capital in the hands of a British shareholder. That, he submits depends upon what character has been given to the distribution by the proper law governing the foreign country, in this case the law of Maryland; and he submits that the law of Maryland has given the character of capital to assets distributed in a partial liquidation, even though the conception of a distribution in partial liquidation is not known to the law of England. He submits that a distribution of this kind has the same effect *pro tanto* as a liquidation in this country, where the moneys distributed are capital and not a taxable profit in the hands of a shareholder: see *Commissioners of Inland Revenue* v. *Burrell*, 9 T.C. 27. In my judgment, however, this analogy is a false one. In a winding-up, as on a reduction of capital, the share capital does not remain intact, whereas it is an essential condition on a distribution in partial liquidation that it should do so. As was pointed out in *Burrell's* case, referring to what Scrutton, L.J., said in *Commissioners of Inland Revenue* v. *Blott*, 8 T.C. 101, at pages 121–2, in a liquidation

> "'the liquidator returns to the shareholders (1) their original capital, (2) accretions to capital due to increase in value of the assets of the company, (3) the reserve funds of undivided profits in the company, (4) the undivided profits of the last year of assessment.'"

But the law of Maryland segregates the first of these four funds—namely, that representing the original share capital—from the rest, and preserves it unimpaired. In substance, the distribution made by Certain can, I think, be regarded simply as a capital profits dividend effected in the only way in which it could be effected by the law of Maryland. But however this may be, the decision in *Reid's* case[1], in my judgment, governs any case where, as here, the possession out of the United Kingdom from which the payment in question derives remains intact in the sense in which Lord Simonds used that expression—namely, "so many shares of £10 each in the capital of the company"; or, as applied to this case, 2,000 shares of $1 each in the capital of Certain. Once the distribution satisfies the test in that sense, it is irrelevant, in my judgment, for the purpose of Case V of Schedule D, to inquire whether, in other contexts, the distribution is a distribution of capital.

In my judgment, therefore, the Commissioners erred in law, and this appeal must be allowed. I should, however, perhaps add that nothing which I have said is intended to prejudice the decision in the case in which a foreign company capitalises profits and makes a bonus issue. The question whether bonus shares received by a British taxpayer in such circumstances would be taxable as income must be dealt with when it arises.

Mr. Orr, what is the right Order?

Mr. Alan Orr.—I would ask for an Order allowing the appeal, with costs, declaring that the distribution of the shares referred to in the Case Stated is assessable on the Respondent under Case V of Schedule D, and remitting the case to the Commissioners with a direction to determine the assessment in accordance with that declaration.

Plowman, J.—Mr. Holroyd Pearce, do you agree that that is the right Order?

Mr. R. Holroyd Pearce.—Yes, my Lord.

Plowman, J.—Very well; I make that Order.

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(1) 30 T.C. 431.

The Company having appealed against the above decision, the case came before the Court of Appeal (Lord Evershed, M.R., and Upjohn and Diplock, L.JJ.) on 9th, 12th and 13th March, 1962, when judgment was given unanimously against the Crown, with costs.

Mr. Philip Shelbourne and Mr. R. Holroyd Pearce appeared as Counsel for the Company, and Mr. John Foster, Q.C., Mr. E. B. Stamp and Mr. Alan Orr for the Crown.

Lord Evershed, M.R.—The question in this appeal is whether certain shares which were issued to the Appellant Company, Lazard Investment Co., Ltd., are properly to be described, in the circumstances which I will later relate, as constituting income arising from a possession out of the United Kingdom within the language of Case V of Schedule D to the Income Tax Act, 1952. The Lazard Company is an investment-holding company, and it is therefore not in doubt that the subject-matter of the appeal is taxable, if at all, only under Case V of Schedule D.

Some time in the year 1955, the Lazard Company purchased 2,000 common shares of the par value of $1 each in a company known as Certain-teed Products Corporation, which was a company incorporated under the laws of the State of Maryland in the United States of America; and for those common shares the Lazard Company paid a total sum of £21,397 14*s.* 3*d.*—a figure, roughly speaking, of $30 a share, from which it follows that, since the company's original incorporation in the year 1917, its transactions had been so successful that the stock had increased in value to the premium value of nearly $30 a share. This corporation, Certain-teed, at the time of which I speak, carried on two distinct businesses. One was the manufacture and sale of asphalt roofing products, and the other was the manufacture and sale of gypsum and paper products. It is stated in the Case, and is no doubt correctly stated, that at the time of which I am speaking —in the last decade—these two businesses were not, perhaps, very happily or conveniently associated together. The gypsum and paper products business is said to have been one that was growing, and which required, therefore, the stimulus of a policy appropriate to a growing concern. The other business, the asphalt roofing products, appears, by contrast, to have been more static. Those concerned for the affairs of Certain-teed Products therefore came to the conclusion that these two businesses could not properly, conveniently, to the best advantage, be run together; that they must be separated. In those circumstances, what was done, putting it quite briefly, was this. All the assets of the Certain-teed company which were properly appropriate to the gypsum and paper products business were disposed of to another, newly-formed, company called Bestwall Gypsum Co. In consideration for the transfer of all those assets appropriate, as I say, to the gypsum business, the Bestwall company undertook to discharge all Certain-teed's liabilities also appropriate to that business, and issued to the Certain-teed company by way of consideration 715,145 common shares, of the par value of $1 each, of its own capital. Then, the Certain-teed company proceeded to distribute among its own stockholders the 715,145 common shares of the Bestwall company. So far as the Lazard Company is concerned, it meant that it received 666⅔ units of these common shares in the Bestwall company—that is to say, one of such common shares for every three shares in the Certain-teed corporation.

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Having regard to the argument which was put forward strenuously on the part of the Crown and which found favour with the learned Judge, I think it is desirable to note (though I shall not take time on it) the figures representing the assets and liabilities of the Certain-teed Products Corporation, as they were, so to say, severed for the purposes of this transaction. They will be found at pages 12 and 13 of Exhibit F attached to the Case Stated, being a notice of a special meeting of the stockholders of Certain-teed to be held in July, 1956, in which is set out at length and in detail the transaction to be carried out. Thus you find, if you look at the liabilities side, that substantially all the items are severed on these sheets, and those which are regarded as appropriate to the gypsum company are then so attributed. Among the items on the liabilities side you get, at the foot, as retained earnings from 1944, a total figure of $37,000,000; and that figure is apportioned so that the Bestwall Gypsum Co. takes over rather more than $17,000,000 of that sum. Put in plain English, what that amounted to was that the accumulated trading profits of the Certain-teed company, represented by this very large figure, were apportioned between the two businesses so that the Bestwall company was treated as becoming entitled, or became entitled, to a substantial portion of those earned but undistributed profits.

Now, that is the broad nature of what was done; and it is quite clear—and this was the basis of the argument of Mr. Foster and Mr. Stamp—that if what I have described had been carried out, substantially as I have described it, by a company incorporated in this country or in accordance with English law, as it well could have been, the result would have been that the stock ultimately distributed by Certain-teed among its stockholders would have represented a distribution of profits of the corporation made since it had started operations. In other words, if we were here dealing with a corporation the powers and nature of which were governed by English law or law which was analogous thereto, there would, I think, be no doubt that the stock which was received, the 666⅔ shares in the Bestwall company, would have been treated for the purposes of taxation as a distribution by way of dividend paid out by the company, the Certain-teed company; and that, as in the case of *Commissioners of Inland Revenue* v. *Reid's Trustees,* 30 T.C. 431, it would have attracted Income Tax under Case V of Schedule D. I shall, a little later, refer to the *Reid's Trustees* case because, of course, it was the foundation of the Crown's argument. Put, I think, fairly but briefly, what is said is that you cannot, in cases of this kind, have what is called a *tertium quid.* Either that which is distributed is a distribution of capital, which can be done only in the course of a liquidation or as the result of some process of capitalisation (or, alternatively, by way of reduction of capital); or it must be a dividend, it must be a distribution of profits so that the subject-matter is, within the terms of Case V of Schedule D, income of property outside the United Kingdom: and it is said that the language of the learned Lords in the *Reid's Trustees* case leaves no escape from that conclusion. But, as I stated earlier, the fact is that this company, Certain-teed Products Corporation, is a creature of the law of the State of Maryland. What we call a limited company is, of course, a *persona ficta.* What it can do and what is the effect of what it does do must depend upon the law which affects it and which describes, governs, limits the powers that such a corporation has. So, in the present case, the question comes down to this: Whether, in the light of the evidence which was given and which is recorded in the Case Stated, and of the findings which the Special Commissioners arrived at as a matter of fact on that

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evidence, the character of that which was distributed—in this case 666⅔ shares—is not income of a property outside the United Kingdom but is in truth something different—namely, is capital, not income at all. As I say, that depends upon the very special circumstances of this case: the evidence and the conclusions to be drawn, and properly to be drawn, from it.

I turn, in those circumstances, to the relevant part of the Case Stated. In paragraph III is set out an extract from the Maryland Corporation Law, Article 23, Section 70. I shall not take time in this judgment to read the whole of it, but it opens thus:

> " (Distributions in Partial Liquidation.) (a) If authorised in the manner provided in subsection (b) of this section, any corporation of this State may, from time to time, declare a partial liquidating distribution to stockholders and in payment thereof may distribute a portion of its assets in cash or property, subject to the following restrictions ".

There are then restrictions which include, save as therein stated, the restriction that no distribution is to be declared or made when what is called the stated capital (which we are told, and I have no doubt rightly, really means the nominal share capital) is impaired or when the payment would impair the stated capital of the corporation. I have read that because it is fundamental to the argument based on certain language in the *Reid's Trustees* case that this partial liquidation or liquidating distribution (call it what you will) has been to leave the capital, as we understand that phrase—the nominal capital and what represents it—intact.

I will not read more of Article 23, Section 70, but in the next paragraph of the Case Stated there are set out what are described as facts found from the evidence of a lawyer, Mr. McKenny White Egerton, a partner in the firm of Piper and Marbury, of Baltimore, in the State of Maryland. After stating what his qualifications are, and so on, in the first sub-paragraph it is stated:

> " The provisions of Section 70 of Article 23 "

—to which I have just alluded—

> ". . . were taken verbatim from the model Act. Prior to 1951 there was no provision in Maryland corporation law dealing with partial liquidation. Indeed, in 1947 the concept of partial liquidation was a novel one and had been embodied in the law of only a few States."

Then, in the next sub-paragraph, it appears that Mr. Egerton was consulted by the Certain-teed corporation, and that he advised that what was intended to be done—what was called the " hiving-off " of the gypsum business—would constitute partial liquidation and that it should therefore be done in accordance with the provisions of the law—requiring, incidentally, not merely a resolution of the directors but a resolution, with a two-thirds majority, of the stockholders. Then, sub-paragraph (3) states:

> " Certain-teed effected the ' hive-off ' by proceeding under the said Section 70. Certain-teed did not declare a dividend: under Maryland law it would not have been possible to effect this ' hive-off ' by way of a declaration of dividend. What the stockholders received from Certain-teed was part of Certain-teed's capital assets, represented by stock in Bestwall. Put in another way, the distribution effected a division of capital assets formerly owned by Certain-teed and now owned in part by Certain-teed and in part by Bestwall."

Then Mr. Egerton goes on to point out that, according to the local law of Maryland, if any of the shares of Bestwall became distributable to the trustees of a settlement, they would, by that law, be capital of the trust and not property of the life tenant. Mr. Egerton referred to an observation of

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Lord Normand in the *Reid's Trustees* case(1), and proceeded, in the last sub-paragraph, as follows:

> "As a result of the distribution by Certain-teed in partial liquidation, under Maryland law [the Lazard Company's] original interest in Certain-teed did not remain intact. Under that law the Courts of Maryland would look for the substance of the transaction."

That was that the original interest of the Lazard Company was in the entirety of Certain-teed's capital assets, but its subsequent interest was comprised in its combined holdings of stock in the two companies, which in reality represented what originally had been the holding in the one company, Certain-teed.

> "Without any question,"

continues the sub-paragraph,

> "under the law of Maryland [the Lazard Company] did not receive a dividend from Certain-teed, but received capital."

The Special Commissioners, having heard all that evidence and considered it, stated their conclusion (see paragraph VII of the Case). Again, I shall not read the whole of it, but the conclusion begins by saying that they find as a fact that

> "Certain-teed did not declare a dividend";

that

> "in the circumstances of the present case the distribution to the shareholders could not, under the law of the State of Maryland, have been made as a dividend";

and, finally:

> "We are of opinion, and so hold, that the 'partial liquidating distribution' received by [the Lazard Company] was not income arising from [its] sharehold ing in Certain-teed, but was a distribution of capital made in accordance with powers conferred by the relevant company law"

—that is, the Maryland law. They continued:

> "Such a distribution must, in our view, be regarded as diminishing the rights previously held by [the Lazard Company] in Certain-teed"

—and on that last observation I would myself prefer to express no view. I am not quite satisfied that that conclusion is right; but, in any case, it does not seem to me to be necessary.

What was said, in face of all that material, on the part of the Crown was that, after all, this description of the transaction as a partial liquidation was just a label: it did not really mean anything which need affect the answer to this case. It was said that it was not really in the least like a liquidation: there was no liquidator appointed, or anything of the kind; and it was simply calling by rather inappropriate language a transaction which, if carried out (as it would have been) in the way in which I have described it by an English company, would simply have been a sale of certain of the assets representing accumulated profits, with the consequence which the *Reid's Trustees* case would undoubtedly justify.

But, having given the matter such thought and attention as I can, I cannot accept the view that this formula is just a label. If the Certain-teed company had chosen to go into liquidation, to sell the whole of its assets

(1) 30 T.C. 431.

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to another company in consideration of shares and then to distribute the purchasing company's shares among its stockholders, that would have been a perfectly normal type of reconstruction by way of liquidation ; and I must say that it seems to me, particularly in the light of what Mr. Egerton said, that this transaction as it was carried out can fairly and properly be described as a partial liquidation. They did not wind up the whole business. What they did do was to wind up the gypsum and paper business, which transaction they carried out in exactly the same way as they would have wound up the whole of their business had that been their intention—namely, by disposing of all the assets relating to the gypsum business to another company which, in consideration, took over an appropriate part of the liabilities and paid for the subject-matter of the transfer by the issue, fully paid up, of its own stock. It seems to me that what was done is, and can and should properly be described as, a partial winding-up ; and, carried out in accordance with the law, and subject to the limitations imposed by the law, of Maryland, I cannot myself see why Courts in England should not give effect to what was done by a Maryland corporation under Maryland corporation law. If that is right, it must, as I conceive, follow that the character of that which was handed out, that which was received by the Lazard Company, was not a dividend or anything that can be described as a dividend or by some other appropriate synonym, but represented a distribution of capital assets as upon a partial winding-up ; and if that is so, then it seems to me equally to follow, and necessarily to follow, that these 666⅔ shares of the Bestwall company cannot properly be called income arising from a possession outside the United Kingdom.

It only remains for me to say something about the *Reid's Trustees* case —the full name being *Commissioners of Inland Revenue* v. *Trustees of Joseph Reid (Deceased)*, 30 T.C. 431. That was a case where a South African company had sold, at an appreciable profit, certain " stands " which it had acquired at various dates, so that after the sale it had a substantial sum representing the profit made on those sales. True, it was described, and properly described, as a capital profit, in the sense that it represented the realised appreciation in the value of certain capital assets of the company ; but the directors of the company then appear to have resolved to distribute two dividends, both so described. The first dividend was a dividend of 20 per cent., payable from capital profits ; and that, in terms of cash, meant, so far as this case is concerned, a sum of £6,000 odd, being the trustees' appropriate share as stockholders of the realised profit on the " stands ". The second was a dividend of 15 per cent., payable out of the company's trading profits. The question then arose whether the trustees ought to pay Income Tax under Case V of Schedule D upon the £6,000 odd as being income from a possession outside the United Kingdom. There was no evidence whatever as to any special law governing this company and affecting its powers in South Africa, and therefore the House assumed—as it was bound to do—that, as a corporation, its powers and transactions were governed by a law similar to that which would govern an English company. In the light of those circumstances it was inevitable, as the noble Lords pointed out in their speeches, that what had been divided, although it arose from the realised increase in value of capital assets, was a dividend. It could not be anything else. Although the company did not purport to reduce the capital, it did not capitalise the profits or issue fully-paid shares : it simply distributed something representing the profits realised, and it was therefore a dividend.

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It is in the light of those facts that one must, I think, regard certain language used by the noble Lords in their speeches. Thus, Lord Simonds, at page 440(1), says this :

> " They must work upon a broader basis, and I cannot imagine a safer or better one, where the question is as to income arising from a foreign possession, than to ask whether the corpus of the asset remains intact in the hands of the taxpayer. That question can, in the case of the shares here in question, only be answered in the affirmative. The shares the Respondents held before the distribution of dividend they still hold intact. The dividend they received was income arising out of those shares."

It was suggested, as I followed the argument, that if, therefore, it could be postulated of the 2,000 shares which the Lazard Company held in the Certain-teed corporation that those shares remained intact—namely, they still had the same shares and therefore the same rights in whatever was the business and other assets of the Certain-teed corporation—it must follow that what was received was a dividend. I am afraid I cannot accept that, and I venture to think that Lord Simonds could not have intended so to state if it would mean, in a case such as this, disregarding altogether the special local law which governed the performance of the foreign corporation and, as I think, governed also the character of that which was distributed.

Lord Normand said(2) :

> " The payment was quite properly described as a dividend and a dividend is at least *prima facie* income of the recipient. In law capital cannot be returned to shareholders by a mere money distribution whether called a dividend or by some other name, and there was in this instance no return of capital. The shares of the company remained after the distribution intact and precisely as they were before it."

Again, a little later(3) :

> " Your Lordships are not in this appeal concerned to construe the terms of the trust deed, and I therefore express no opinion whether the dividend under consideration was properly treated as the revenue of the liferentrices, but these authorities show that a distribution of money to shareholders out of profits realised by the sale of the company's assets without any alteration of the share capital is normally a payment of the nature of income."

To those observations I venture to make the same comment as I made in regard to Lord Simonds': they were related to a corporation, the powers and the transactions of which were governed by the same law as the English company law.

I need not, I think, multiply citations. Lord Morton of Henryton said something much to the same effect at page 445(1). In his view, it could be put very simply:

> " All that happened was that certain cash belonging to the company, and representing part of the profit realised by the sale of a capital asset belonging to the company, was paid away as a dividend."

Nothing less like that, I should have thought, happened in this case.

Finally, I refer just to this passage in Lord Reid's opinion at page 450(1) :

> " There are many ways in which a company can deal with its profits. If it adopts certain methods the result is the creation of new capital assets. If it adopts other methods the result is the receipt of income by its shareholders. In either case it is immaterial whether the profits were trading profits or capital profits. It is true that, owing to the special provisions of the Income Tax Acts which distribute liability for Income Tax (including Sur-Tax) between a British company and its shareholders, a dividend paid by a British company out of its

(1) 30 T.C. (2) *Ibid.*, at p. 442. (3) *Ibid.*, at p. 443.

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> capital profits is not taxable. But there are no provisions applicable to a foreign company which bring about this result. I can find no satisfactory alternative to the view that, if a foreign company chooses to distribute its surplus profits as dividend, the nature and origin of those profits do not and cannot be made to affect the quality of the receipt by the shareholder for the purpose of Income Tax."

If I may respectfully say so, I wholly agree. It does not matter what is the nature of the profits which come to be distributed. What is essential is: what is the character of that which, in the end of all, is distributed? Applying what Lord Reid said to the present case, I think that the local law so operated that what this company—Certain-teed—did was to distribute, not a dividend consisting of or made up of profits, whether capital or income, but part of its capital assets as though that part of the business had been wound up.

For these reasons, therefore, with all respect to the argument addressed to us and to the view of the learned Judge, I think that this appeal succeeds and that the answer is that these shares were not income of a possession of the Lazard Company out of the United Kingdom.

Upjohn, L.J.—I agree with the judgment that has just been delivered. The authorities to which we have been referred clearly establish two propositions.

First, when a company makes a distribution among its shareholders, the question whether such distribution is capital or income is determined against all the world by the legal machinery which the company employs to make the distribution—not, let me add, by the label which it attaches to that distribution. Thus, it is clearly settled that an English company making a distribution even of what is, in the hands of the company, a capital non-trading profit must be treated as income in the hands of the shareholders (though it may be tax-free income: see Section 184 of the Income Tax Act, 1952), unless the company either (*a*) pays it out on a reduction of capital or on a reduction of the share premium account under the provisions of the Companies Act, 1948; or (*b*) in a liquidation; or (*c*) applies the distribution in paying up a new issue of its own bonus shares which it then distributes among its shareholders.

Secondly, when considering the question of income arising from foreign possessions under Case V of Schedule D, the precise interest taken by the person owning the foreign possession must be determined by the proper law of the foreign possession. That seems to me necessarily to flow from *Garland* v. *Archer-Shee*, 15 T.C. 691. What is to happen when a foreign company makes a capital distribution in accordance with its local law but in a manner not available to an English company by our law?

I agree with the Crown's argument to this extent: that the relevant United States law cannot conclusively determine whether the receipt of the shares in Bestwall are income or capital for the purposes of the Income Tax Act, 1952; but until the true nature of the receipt is ascertained by, in this case, the law of the State of Maryland, I do not see how it is possible to begin to solve the problem. Though I do not find all the observations of the Special Commissioners in paragraph VII of the Case Stated easy to follow and do not accept all of their conclusions, I do not think it can be doubted that they have found as a fact (and the law of Maryland is, of course, a matter of fact for them to determine) that by such law these shares were distributed as

capital and if, for example, they had been received by a trustee of a settlement in Maryland, would (subject to any special provisions in the settlement) be received as capital thereof. It is no doubt true—and, indeed, an essential prerequisite of the operation of Section 70 of the Maryland Corporation Law —that the original capital of the company should be and remain unimpaired or intact throughout the operation in this sense, that the shareholders should hold after the transaction exactly the same shares of the same nominal value as before. But does it follow from this that because, as a matter of English law, the foreign possession (that is, the shareholding) is in law the same as before, then the issue and distribution among shareholders of the Bestwall shares are necessarily a surplus and income for the purposes of the Income Tax Acts? I do not think so. The law of the State of Maryland, which is the proper law of the distribution, looks at the substance of the transaction and, subject to the stringent safeguards contained in Section 70, by permitting a partial liquidation affords a convenient and easy method of "hiving-off" part of a business in exchange for shares. The fact that in this country we have no precisely equivalent statutory machinery for performing an essentially capital operation in the same way does not, in my judgment, mean that we must apply the criteria applicable to an English company to the exclusion of the local law.

We were properly pressed with the speeches of the noble Lords in *Reid's* case, 30 T.C. 431, and particularly with those passages where they referred to the relevant shareholding remaining intact. Literally read, that is equally true of this case. That, however, was a very different case; for it was the case of a distribution by a South African company which made a dividend payment of 20 per cent., payable from capital profits realised on the sale of properties. There was no suggestion that the law of South Africa differed in any relevant respect from that of this country, whence the result flowed that the payment was necessarily income. Their Lordships did not have to consider the problem which is now before us; and in my judgment it would not be right to apply their observations, dealing with entirely different circumstances, to this case.

The local law governing the relevant transaction provided a reasonable and fair statutory method of achieving an essentially capital operation, regarded in a business sense. The operation being properly performed in accordance with the local Statute, the shares distributed in the Appellant Company's hands are capital; and as such they should be so regarded, in my judgment, for the purposes of our Income Tax law. I agree that this appeal should be allowed.

Diplock, L.J.—I also agree. The sole question is whether the Bestwall shares distributed to Lazard Investment Co., Ltd. (which, like the Special Commissioners, I shall refer to as "Lico"), are income arising from possessions out of the United Kingdom in the year of assessment.

If it were permissible to look at the substance of the matter, piercing the veil of the corporate fiction, Lico before the distribution had an aliquot share in two businesses owned and operated by one Maryland company: after the distribution, it had the same aliquot share in the identical two businesses owned and operated by two separate Maryland companies. Even if it were not permissible to pierce the veil of the corporate fiction—and I accept that it is not for Income Tax purposes—the substance of the matter is that Lico's income-earning foreign possession from which its

(Diplock, L.J.)

relevant income arose, its shareholding in Certain-teed, was converted into two income-earning foreign possessions: its shareholding in Certain-teed and its shareholding in Bestwall. In substance, all that happened—and it was so treated in Lico's accounts—was a change in its foreign capital investment, not a receipt by Lico of income from its foreign capital investment.

The Crown's argument is founded on the proposition that anything which a shareholder in a corporation which is not in liquidation receives from the corporation, other than bonus shares in the corporation itself, can only be distributed to him either by way of income or by way of return of capital; that the Bestwall shares were not distributed to Lico by way of return of capital because, notwithstanding the distribution, it continued to hold the same number of shares of the same nominal value in Certain-teed; and that therefore the Bestwall shares must have been distributed to Lico by way of income. This syllogistic proposition must depend upon, among other things, the validity of its major premise. Its major premise is based upon an acceptance of the corporate fiction, and the validity of the major premise must depend upon the legal powers with which the *persona ficta,* the corporation, was endowed by its proper law—namely, that of the State by which it was created.

The major premise is true of corporations constituted under English law, and was assumed to be true, in *Reid's Trustees* case(1), of corporations constituted under South African law. Whether it is true of corporations constituted under the law of Maryland is a question of foreign law, and thus a question of fact to be determined on evidence by the Special Commissioners. Their vital finding of fact on the expert evidence of Maryland law, which they accepted, is:

> "Without any question, under the law of Maryland Lico did not receive a dividend from Certain-teed, but received capital."

That the distribution of the Bestwall shares may not constitute a "return of capital" in the sense in which that expression has been used in relation to companies constituted under English law or some similar system, such as South African law, is, for the reasons I have indicated, immaterial. On the other hand, it is not conclusive as to the capital nature of the distribution that the relevant Maryland Statutes refer to such a distribution of assets as a partial liquidation of the corporation. I agree with Counsel for the Crown that one must look to see the true legal character of what was done, and that the Court is not bound by the technical meaning in English law of the particular expression used by a foreign Legislature. It is likewise inconclusive, although not irrelevant in determining the true legal character of what was done, that what was distributed was a capital asset in the hands of the corporation that distributed it; for the proper law of the corporation, as in the case of English law, may prohibit a corporation from distributing accrued capital assets to its shareholders except as profits earned by the original capital employed.

What is material is that, under Maryland law, a corporation can, if the conditions laid down by the Statute are fulfilled, distribute part of its capital assets to its shareholders in the form of capital without going out of existence or reducing the number, or nominal value, of its own shares. That, upon the evidence, is what, under Maryland law, Certain-teed could

(1) 30 T.C. 431.

do. That, upon the evidence, is what it did. In the case of a Maryland corporation, the major premise of the Crown's proposition is, in my view, false. The proper law applicable to the transaction is Maryland law, and I know of no principle—and none seems to me to be laid down in *Reid's Trustees* case[1]—which compels or entitles an English Court to judge of the legal nature of the transaction by a system of law other than the proper law—particularly where, as in this case, the legal nature of the transaction under its proper law, by a coincidence which is happy, if unusual, in Income Tax law, corresponds to the substance of the transaction as well.

I, too, would allow this appeal.

Mr. Philip Shelbourne.—Would your Lordships say that the appeal is allowed with costs?

Lord Evershed, M.R.—That would be right, Mr. Foster?

Mr. John Foster.—That is right, my Lord. I ask for your Lordships' leave to appeal.

Lord Evershed, M.R.—This depends entirely upon the very special circumstances of the case.

Mr. Foster.—My Lord, it would be very easy for everybody to distribute their retained profits by passing this kind of law.

Lord Evershed, M.R.—I do not know. If they do, as my brother Diplock has pointed out, they would appear to make the law equivalent to the substance of the transaction. Nobody could possibly suggest that, if you were right, the result would be just.

Mr. Foster.—I think that is re-opening the appeal, my Lord. In my respectful submission, it is just, but I failed to convince your Lordships about that.

Lord Evershed, M.R.—I do not know what you have got to say, Mr. Shelbourne, but there is a division of opinion. I am not saying you should not have leave, Mr. Foster, but I do not disguise a certain feeling of shock.

Mr. Foster.—My Lord, I tried to argue that it was just: your Lordships did not accept my argument.

Lord Evershed, M.R.—I am thinking whether it would be fair to impose upon the Crown any obligation about costs.

Mr. Shelbourne.—My Lords, if I might address your Lordships for a moment on this: as your Lordship has already said—and I can only respectfully echo that—this is a very special case on its own facts. It does not, in my respectful submission, involve a great question of principle. I would also say that, as your Lordships will see from the Stated Case, there is only a quite small sum of tax involved. I would, therefore, respectfully ask your Lordships to refuse the Crown's application for leave to appeal.

Lord Evershed, M.R.—You say quite a small sum of tax. It is the Income Tax on £12,000. To you that is trivial, no doubt, but it is not entirely negligible.

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(1) 30 T.C. 431.

Mr. Shelbourne.—There is, though it is not shown in the Stated Case, my Lord, a question of double taxation relief which in fact reduces the sum of tax to less than it appears ; but my real ground for asking your Lordships to refuse this application is that this is an entirely special case on its own facts.

Mr. Foster.—In answer to that, I submit, with respect, that it is a question of principle ; the principle being whether, when looking at the proper law, you look at it in its comprehensive sense or whether—as have been the grounds of the appeal—you do not look at it until you characterise it.

Lord Evershed, M.R.—Yes, Mr. Foster. I think, having regard to your argument, and so on, it would be right to give you leave. We are only wondering whether it is right that there should be any condition about costs, in the circumstances.

Mr. Foster.—My Lords, I am instructed not to agree to any terms.

(*The Court conferred*)

Lord Evershed, M.R.—I have made my protest, Mr. Foster ; but, having done so, I think we ought to give leave to appeal.

Mr. Foster.—It would be otiose to try and persuade your Lordship that it is just.

Lord Evershed, M.R.—If the House say we were wrong, then there you are.

Upjohn, L.J.—What about the costs in the Court below?

Mr. Foster.—They go, my Lord.

Lord Evershed, M.R.—Yes ; very well.

The Crown having appealed against the above decision, the case came before the House of Lords (Lords Reid, Cohen, Jenkins, Guest and Pearce) on 11th, 12th and 13th March, 1963, when judgment was reserved. On 10th April, 1963, judgment was given unanimously against the Crown, with costs.

Mr. John Foster, Q.C., Mr. E. B. Stamp and Mr. Alan Orr appeared as Counsel for the Crown, and Mr. F. N. Bucher, Q.C., and Mr. J. Holroyd Pearce for the Company.

Lord Reid.—My Lords, the Respondent Company was assessed to Income Tax for the year 1956–57 in the sum of £12,507 under Case V of Schedule D. In 1955 it had bought, for £21,397, 2,000 shares in Certain-teed, a corporation incorporated in the State of Maryland. That corporation was carrying on two separate businesses as manufacturers of asphalt roofing products and as manufacturers of gypsum and paper products. It was thought to be in the interest of the latter business that it should be "hived-off". This was done by a procedure authorised by the laws of that State, a distribution in partial liquidation. A new company called Bestwall was formed and the gypsum business was sold to it with all the assets used in that business. The consideration was 715,145 shares of Bestwall, and these shares were distributed to the shareholders of Certain-teed, who received one for each three Certain-teed shares. The prices on the

New York Stock Exchange for Certain-teed shares cum Bestwall and then for Certain-teed shares ex Bestwall showed that the business sold to Bestwall was considerably more valuable than the business which Certain-teed retained.

In this distribution the Respondent Company received 666⅔ Bestwall shares free of cost and it allocated the original purchase price so that much the greater part was attributed to its Bestwall shares. It was assessed on the basis that these Bestwall shares were income within the meaning of Case V. The Special Commissioners discharged this assessment. Their decision was reversed by Plowman, J., but restored by the Court of Appeal.

The Crown now maintain that these Bestwall shares should be held to have been received by the Respondent Company as income. They rely on the rule applicable to foreign companies in countries whose law is similar to the law of England. Under our law there is no doubt that every distribution of money or money's worth by an English company must be treated as income in the hands of the shareholders unless it is either a distribution in a liquidation, a repayment in respect of reduction of capital (or a payment out of a special premium account) or an issue of bonus shares (or it may be bonus debentures). But the Respondent Company maintains that this case depends on the law of Maryland. Partial liquidation is unknown to our law, but its effect was explained in evidence by Mr. Egerton, an eminent member of the Bar of Maryland, and in light of that evidence the Special Commissioners have made findings of fact as to the law of Maryland, which are not challenged. The most important findings of fact are (paragraph IV of the Case Stated):

> "(3) Certain-teed effected the 'hive-off' by proceeding under the said Section 70. Certain-teed did not declare a dividend: under Maryland law it would not have been possible to effect this 'hive-off' by way of a declaration of dividend. What the stockholders received from Certain-teed was part of Certain-teed's capital assets, represented by stock in Bestwall. Put in another way, the distribution effected a division of capital assets formerly owned by Certain-teed and now owned in part by Certain-teed and in part by Bestwall. (4) In the case of a distribution under the said Section 70 to a stockholder who held Certain-teed stock as a trustee for a Maryland trust, the question as to whether the distribution is to be regarded as principal or income of the trust is answered by Section 3(2) of Article 75B (Exhibit 'J'). The relevant words are 'All receipts . . . in liquidation of the assets of a corporation'. Under Article 75B the Bestwall stock would belong to 'remaindermen' and not to 'tenants' (as defined in Section 1 of Article 75B). The said Article 75B was copied by the State of Maryland from one of the model acts promulgated by the Commissioners on Uniform State Laws; most of the States of the Union have adopted a similar provision. The words 'in liquidation' in the said Section 3(2) cover a partial liquidation as well as a full liquidation. (5) The observation of Lord Normand in *Commissioners of Inland Revenue* v. *Reid's Trustees,* 30 T.C.431, at page 442, viz.: 'it is incorrect, both in law and in substance, though I would prefer to draw no such distinction, to treat the shareholder as possessing the capital assets of the company', would be a correct statement of the law in Maryland. (6) As a result of the distribution by Certain-teed in partial liquidation, under Maryland law Lico's[1] original interest in Certain-teed did not remain intact. Under that law the courts of Maryland would look for the substance of the transaction. The substance of this transaction was that Lico's original interest was in the entirety of Certain-teed's capital assets; Lico's subsequent interest was comprised in its combined holdings of stock in Certain-teed and in Bestwall, and those two holdings represented in reality the identical assets in which it had its original interest. Without any question, under the law of Maryland Lico did not receive a dividend from Certain-teed, but received capital."

I would first observe that Mr. Egerton's evidence and these findings relate not to the general effect of partial liquidation in Maryland but the facts of this

(1) The Respondent Company.

(Lord Reid)

case. If the Courts of Maryland look for the substance of each transaction, we cannot assume that the same results would follow if the facts were substantially different. It was suggested in argument for the Crown that, if the findings in this case are given what seems to me to be their natural meaning, this procedure by way of partial liquidation could be used for tax avoidance ; all that would be necessary would be to use accumulated profits to buy shares in another company and then distribute these shares by way of a partial liquidation, when the shareholders would receive them as capital. But that would be quite a different case from the present case, and I am not at all prepared to assume that the Courts of Maryland, looking for the substance of the transaction, would reach the same result. It may well be that tax avoidance is not unknown in the United States, and that the Courts there have appropriate means for dealing with it. In the present case, partial liquidation appears to me to be an apt name for what was done : it did not involve the death of the company, but it did involve the amputation of one of its businesses.

In deciding whether a shareholder receives a distribution as capital or income, our law goes by the form in which the distribution is made rather than by the substance of the transaction. Capital in the hands of the company becomes income in the hands of the shareholders if distributed as a dividend, while accumulated income in the hands of the company becomes capital in the hands of the shareholders if distributed in a liquidation. In the present case, the form of the distribution was one unknown to our law—distribution in a partial liquidation. By the law of Maryland, which governs the company and which authorised this distribution, the shares distributed were capital in the hands of the shareholders. Why, then, should we regard them as income? It is said that, if this had been an English company and it had done what Certain-teed did, these shares would have been income in the hands of the shareholders. But an English company could not do what Certain-teed did, for it could not distribute in a partial liquidation. No doubt an English company could have reached the same result by using a different method—declaring a dividend. But it is found as a fact that it would not have been possible in Maryland to effect this transaction by way of a declaration of dividend. So why are we to hold something to be a dividend which, by the law of Maryland, was not and could not be a dividend? There is no question here, of the foreign law producing a result which is unreasonable or contrary to our idea of justice.

The argument for the Crown was based to a large extent on what was said in this House in *Commissioners of Inland Revenue* v. *Reid's Trustees*[1], [1949] A.C. 361. In that case a dividend in the form of cash was received from a South African company by a taxpayer in Scotland. It is clear from several of the speeches that this dividend was received as income, but its source was profit from appreciation of capital assets of the company. It was assumed, in the absence of evidence to the contrary, that the law of South Africa was the same as the law of England : so the dividend would be received in South Africa as income. But the taxpayer maintained that it was not taxable income, founding on the fact that a similar dividend paid by a British company would not be subject to Income Tax. This was held to be irrelevant : the dividend was income from a foreign possession and was therefore within

(1) 30 T.C. 431.

(Lord Reid)

Case V. The decision is, therefore, not in point, but the Crown relied on statements which I shall quote. Lord Simonds said, at page 373(1):

> ". . . I cannot imagine a safer or better [basis], where the question is as to income arising from a foreign possession, than to ask whether the corpus of the asset remains intact in the hands of the taxpayer."

Lord Normand said, at page 374(2):

> "It seems to me beyond dispute that 'the possessions' are the shares. . . . In law capital cannot be returned to shareholders by a mere money distribution whether called a dividend or by some other name and there was in this instance no return of capital. The shares of the company remained after the distribution intact and precisely as they were before it."

Lord Morton of Henryton said, at page 379(3):

> "This sum must be either income arising from that possession or part of the capital of that possession."

And Lord MacDermott said, at page 383(4):

> "No doubt the shares abated in market value after the payment of the dividend, but they nevertheless remained intact. The ripe tree loses weight and worth when it sheds its fruit, but the fruit remains fruit and no more unless in its fall it has taken part of the tree with it."

Accepting that test, as I do without reservation, the question is whether "the corpus of the asset" or "shares of the company" or "the capital of the possession" did or did not remain intact after the Bestwall shares were distributed: or whether the Bestwall shares were merely fruit or had they in their fall taken part of the tree with them.

It is not disputed that the nature of a taxpayer's right to his foreign possession must be determined by the foreign law—*Archer-Shee* v. *Garland*(5), [1931] A.C. 212. So we must go to the law of Maryland to find whether the taxpayer's capital asset remained the same, and it is found as a fact:

> "(6) As a result of the distribution by Certain-teed in partial liquidation, under Maryland law Lico's(6) original interest in Certain-teed did not remain intact",

and then the reason is given, followed by the statement that the shareholder received capital. The plain meaning of that appears to me to be that after the partial liquidation the corpus of the Respondent Company's capital asset did not remain intact. And I do not find it surprising that the law of Maryland should so hold; I would expect that after a partial liquidation the corpus would be different. To adopt Lord MacDermott's metaphor, trees in Maryland are unlike trees in England, they can be split and both halves can live: after partial liquidation Certain-teed was only half the original tree, the other half becoming Bestwall. The Crown say that both before and after the distribution the Respondent Company held 2,000 shares of Certain-teed, so its foreign possession or capital asset must be the same. But that is going by our law, which looks to form. We are told that the law of Maryland looks to substance, and in substance the foreign possession did not remain intact. The shares after partial liquidation were not the same in substance as they had been before. So, on the findings of fact as to the law of Maryland, I have no difficulty in holding that this appeal should be dismissed.

My Lords, my noble and learned friend **Lord Cohen** is unable to be present this morning, and he has asked me to say that he concurs.

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(1) 30 T.C. at p. 440. (2) *Ibid.*, at p. 442.
(3) *Ibid.*, at p. 445. (4) *Ibid.*, at p. 448. (5) 15 T.C. 693. (6) The Respondent Company.

Lord Jenkins.—My Lords, in this case I agree with the judgments delivered by my noble and learned friend Lord Evershed, M.R., and Upjohn and Diplock, L.JJ., in the Court of Appeal, and it would serve no useful purpose by repeating them at length. Accordingly, I have very little to add.

Each case in which it is sought to charge with Income Tax under Case V of Schedule D income arising from possessions out of the United Kingdom must turn on its own facts, including as part of those facts whatever foreign law may be found to be properly applicable to such income or possessions. In the present case the proper law has been found to be that of the State of Maryland in the United States of America, and it has been further found (on the evidence of Mr. Egerton, a well-known Corporation lawyer in Maryland) that under Maryland company law it is, within limits, possible and permissible to effect what is known as a partial liquidating distribution, which is a method of returning assets to members of a company in a partial liquidation, extending to part only of such assets, without winding up. It would seem that no comparable procedure exists under United Kingdom company law. Be that as it may, there is, as I understand it, no doubt that according to Maryland law a " partial liquidation distribution " was validly effected in the present case and that it resulted in the receipt by the Company, the Lazard Investment Co., Ltd. (incorporated and carrying on business in England), of the 666⅔ common shares in Bestwall in respect of which Income Tax is now claimed, in addition to the 2,000 common shares of $1 each in Certain-teed originally purchased by the Company, and still held by it.

The Crown claim that the 666 odd shares in Bestwall were income arising from possessions outside the United Kingdom in the shape of the 2,000 shares in Certain-teed acquired by Lazard as already mentioned. I find it difficult to understand how any element of dividend or income could come into this transaction. It seems to me to have been essential to the scheme that the Company's interest in the capital assets made over to Bestwall should be retained as capital and not paid away as income, which, as I understand the position, would have been both inconsistent with the scheme and indeed with Maryland company law.

Mr. Egerton has described very clearly the way in which a partial liquidating distribution works, with special reference to the present case. At paragraph IV (3) of the Case, he said:

> " Put in another way, the distribution effected a division of capital assets formally owned by Certain-teed and now owned in part by Certain-teed and in part by Bestwall."

At paragraph IV (6) of the Stated Case, he said:

> " Without any question, under the law of Maryland, Lico [that is, Lazard Investment Co., Ltd.] did not receive a dividend from Certain-teed, but received capital."

It is interesting to note that, in Mr. Egerton's view (paragraph IV (4) of the Case), on a distribution of Bestwall stock to the trustee for a Maryland trust, such stock would belong to the " remaindermen " and not to " tenants " (i.e., " for life ").

As regards the much-discussed case in your Lordships' House, *Commissioners of Inland Revenue* v. *Reid's Trustees* (1), [1949] A.C. 361, I need only say that I think it should be held distinguishable from the present case on the ground that it was decided without any evidence of the relevant foreign law.

For these reasons, I would dismiss this appeal.

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(1) 30 T.C. 431.

Lord Guest.—My Lords, I have had the advantage of reading the speech delivered by my noble and learned friend on the Woolsack, and I agree that the appeal should be dismissed for the reasons given by him. I only propose to add a very few observations.

The question as to what is the character of the payment by Certain-teed in the hands of a recipient shareholder, the Respondent, falls to be determined by the law of the country in which Certain-teed is incorporated: *Garland* v. *Archer-Shee,* 15 T.C. 693. Certain-teed was incorporated under Maryland corporation law. Being a creature of Statute, the corporation's activities are entirely governed by and subject to Maryland law. The rights of shareholders in that corporation could only be exercised according to Maryland law. The character of a payment in the hands of a shareholder in this country is determined for all purposes by the legal machinery employed by the company acting under the relevant Statutes: see Viscount Haldane in *Commissioners of Inland Revenue* v. *Blott,* 8 T.C. 101, at page 125. In ascertaining the character of a payment to a shareholder in this country, resort must therefore be had to the machinery under English law. Similarly, if the corporation is incorporated under Maryland law, resort must be made to the machinery under Maryland law. Counsel for the Crown argued that the enquiry was whether the Bestwall distribution came within the words of Case V of Schedule D as "income arising from possessions out of the United Kingdom" (Section 123, Income Tax Act, 1952). The question depended on whether the distribution was income according to English law. But the form in which the "partial liquidating distribution" was made under Section 70 of the Maryland code is unknown to our law. To ask what would be the effect of such a distribution if made in England is to embark upon a fruitless inquiry because English law gives no guiding light. According to English law a distribution of capital profits would be income in the hands of the shareholder: *Commissioners of Inland Revenue* v. *Reid's Trustees,* 30 T.C. 431. But this is *nihil ad rem* in the present case, where the distribution has been made under Maryland law. In the Stated Case there are findings of fact as to the law of Maryland, and they leave me in no doubt that according to the law of Maryland there was a capital distribution. In these circumstances, my opinion is that the Special Commissioners arrived at a correct conclusion and the decision of the Court of Appeal was right.

Lord Pearce.—My Lords, I agree with the judgments of the Court of Appeal.

Certain-teed, since its incorporation in Maryland in 1917, had been continuously engaged in the manufacture and sale of asphalt. Since 1926 it had also been engaged in the manufacture and sale of gypsum and paper products. For various commercial reasons, in 1956 it decided to conduct the two businesses as two distinct entities and it separated them accordingly.

If one could regard the commercial substance of the transaction without the necessary formalities and fictions of company law, the Respondent Company before 1956 owned a share in the two businesses conducted together under one management, and after 1956 it owned a like share in the two businesses conducted as separate entities. Its commercial position is therefore substantially unchanged. From this informal aspect it would be surprising if the retention of its share in the gypsum and paper business were to be regarded as income. It would also be surprising if its share in that business were to go to the life tenant under a settlement or were to pay Income Tax before going to the remainderman.

(Lord Pearce)

Undoubtedly, a large portion at least of the assets of Bestwall were the undivided trading and capital profits of the two businesses previously conducted by Certain-teed. But that fact does not, even by English company and Income Tax law, decide whether the Bestwall shares were received by the Respondent as income or capital. The matter was put succinctly by my noble and learned friend Lord Reid in *Commissioners of Inland Revenue* v. *Reid's Trustees* (1), [1949] A.C. 361, at page 386, which dealt with income from a company in South Africa, where the company law was taken to be similar to that in England.

> "There are many ways in which a company can deal with its profits. If it adopts certain methods the result is the creation of new capital assets. If it adopts other methods the result is the receipt of income by its shareholders. In either case it is immaterial whether the profits were trading profits or capital profits. . . . I can find no satisfactory alternative to the view that, if a foreign company chooses to distribute its surplus profit as dividend, the nature and origin of those profits does not and cannot be made to affect the quality of the receipt by the shareholder for the purpose of income tax."

In that case the taxpayer had received a dividend out of capital profits, but there was no liquidation and no reduction of capital. The taxpayer's original capital was intact. It was therefore held that the dividend must be treated as income.

In *Commissioners of Inland Revenue* v. *Blott*, 8 T.C. 101, at page 125, Viscount Haldane said :

> "The company, acting with the assent so given of the shareholders, can decide conclusively what is to be done with accumulated profits. It need not pay these over to the shareholders. It can convert them into capital as against the whole world, including, as I think the principle plainly implies, the Crown claiming for taxing or any other purposes."

In that case it was held that fully-paid bonus shares in the company credited to a shareholder, being distributed as capital, were not income in the hands of the shareholder.

Thus it is not the source from which the assets are distributed but the machinery employed in their distribution which determines the question whether they are received as capital or income. They are received as capital if they are distributed as a bonus issue as in *Blott's* case(2), or on an authorised reduction of capital or in a liquidation : see *Commissioners of Inland Revenue* v. *Burrell*, 9 T.C. 27. If, however, they are distributed in any other way, they are received and taxable as income : *R. A. Hill and Others* v. *Permanent Trustee Co., of New South Wales, Ltd., and Others*, [1930] A.C. 720. But it is possible for a new statutory method of distribution to enlarge the categories of possible capital distribution set out in *Hill* v. *Permanent Trustee* : see In re *Duff's Settlements, National Provincial Bank, Ltd.* v. *Gregson and Others*, [1951] Ch. 923, where the distribution of money paid out of a share premium account under the Companies Act, 1948, was held to have been received as capital. If, however, assets are distributed as shares in another company, that is " merely a distribution of money's worth instead of money " and they " simply represent a dividend " : *per* Rowlatt, J., in *Wilkinson* v. *Commissioners of Inland Revenue*, 16 T.C. 52, at page 59, and *Briggs* v. *Commissioners of Inland Revenue*, 17 T.C. 11, at page 26, respectively.

(1) 30 T.C. at p. 450. (2) 8 T.C. 101.

(Lord Pearce)

It is conceded that had Certain-teed been an English company controlled by English law, its method of distribution could not have constituted a capital distribution and must therefore have been an income distribution, since our law does not allow the process of partial liquidation. But Certain-teed is incorporated under Maryland law, which does allow a partial liquidation whereby part of a company's business or assets may be "hived-off" in the method adopted by Certain-teed in the present case. The stock so "hived-off" belongs to remaindermen and not to life tenants under a trust. The law of Maryland was a question of fact for the Special Commissioners to decide on the evidence before them. They accepted the expert evidence that Certain-teed did not distribute a dividend, and that without any question the shareholders received not a dividend but capital. The distribution was made in accordance with powers conferred by Section 70 (which related to partial liquidation) of the law relating to corporations in the State of Maryland, and by that law the distribution could not have been made as a dividend.

The question whether a receipt is "income arising from possessions out of the United Kingdom" is a question to be decided according to the "law of England": see *Camille and Henry Dreyfus Foundation, Inc.* v. *Commissioners of Inland Revenue*(1), [1956] A.C. 39, at page 44. But it cannot be decided *in vacuo*. The factual situation (which includes the foreign law) has to be examined in order to apply the English law. In *Garland* v. *Archer-Shee*, 15 T.C. 693, at page 711, Rowlatt, J., said:

> "The question of the American law is, what are exactly the rights and duties of the parties under an American trust, and when you find what those rights and duties are, you see what category they come in, and the place they fill in the scheme of the English Income Tax Acts which the Courts here must construe."

A corporation, being a *persona ficta*, owes its existence to the law under which it is created and cannot act except in accordance with it. It is, therefore, impossible to assess the behaviour of a Maryland company on the hypothesis that it has been created by and acts in accordance with English law.

By the law of Maryland, this Maryland corporation has made a distribution of capital. In the hands of the shareholder the distribution is received as capital and not income. It is, therefore, not liable to tax under the English Income Tax Act.

In the present case that conclusion accords with the commercial substance of the transactions. It has been suggested in argument that foreign law might create colourable labels or machinery whereby it could fix upon a distribution a specious appearance of capital when in truth it should be income, and that thus tax could be unfairly avoided. If such a situation arises, it may well be that the English Courts would feel entitled to look behind the labels or even, perhaps, behind the machinery itself to find the true substance of the matter. But in the present case the transaction was admittedly genuine, and I see nothing in the concept of partial liquidation which is wholly out of accord with the notions of English law.

I would dismiss the appeal.

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(1) 36 T.C. 126, at p. 158.

Questions put :

That the Order appealed from 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 ; Linklater & Paines.]