NO. 191—IN THE HOUSE OF LORDS, 12TH NOVEMBER, 1896

ROYAL INSURANCE COMPANY *v.* WATSON (SURVEYOR OF TAXES) (1)

Income Tax—Schedule D—First Case—Deduction—Expenses—In the Agreement under which the Royal Insurance Company acquired the business of the Queen Insurance Company it was provided that the manager of the latter Company should be taken into the service of the former, at a salary of £4,000 a year, with liberty for the Royal Insurance Company to commute the same by payment to the manager of a gross sum on the basis of the Company's Annuity Tables, on condition that he should not at any time accept office under any other fire or life insurance company. Shortly after the transfer of the business the Royal Insurance Company paid the manager the sum of £55,846 8s. 5d. in commutation of his annual salary. The Company in arriving at the amount of their liability to Income Tax for the year 1892–93, claimed to deduct this sum from their profits for 1891–92, the year in which the payment was made.

Held, *that this payment formed part of the consideration for the transfer of the business, and therefore, being capital expenditure, could not be deducted.*

1. At a meeting of the Commissioners for the general purposes of the Income Tax Acts for the Division of Liverpool, held at No. 9, North John Street, Liverpool, within the said Division, on Thursday the 27th day of April 1893, the Royal Insurance Company appealed against an assessment made upon them under Schedule D of the Act 16 & 17 Vict. c. 34 for the year ending 5th April 1893, and claimed an allowance by way of deduction in respect of a sum of £55,846 8s. 5d. paid under the circumstances following :—

2. By the Royal Insurance Company's Act, 1891 (54 & 55 Vict. c. 81), a copy of which is annexed and is to be taken as forming part of this case, the Royal Insurance Company were invested with powers to acquire the whole of the undertaking of the "Queen" Insurance Company, and, in pursuance of this Act, the transfer of the business of the "Queen" Insurance Company to the Royal Insurance Company took place on the 19th of August 1891.

(1) Reported [1897] A.C. 1.

3. By Article 6 of the Agreement between the two Companies aforesaid embodied in the schedule forming part of the Royal Insurance Company's Act, 1891, it is provided that " the services of the present manager of the " ' Queen ' Insurance Company shall be retained by them until the transfer " of the business is completed at a salary at the rate of £4,000 per annum, " and thereafter he shall be taken into the service of the Royal Insurance " Company at the same rate, with liberty, nevertheless, for the Royal Insurance " Company to commute the same by payment to him of a gross sum on the " basis of the Queen Insurance Company's Annuity Tables, applicable to his " then age, on condition that he shall not at any time accept office or employ- " ment of any description under or in connexion with any other fire or life " insurance company. The remainder of the staff of the Queen Insurance " Company shall also be taken over by the Royal Insurance Company."

4. On the transfer of the business the manager of the " Queen " Insurance Company was taken into the service of the Royal Insurance Company at the salary of £4,000 per annum, and shortly afterwards in pursuance of the powers conferred on them by the Sixth Article of the Agreement, and in accordance with its terms the Royal Insurance Company paid him the sum of £55,846 8*s*. 5*d*. in commutation of his annual salary.

5. The Royal Insurance Company contended that in arriving at the amount of their liability for assessment for the year ending 5th April 1893 under the provisions of the Income Tax Acts, the said sum of £55,846 8*s*. 5*d*. was a proper deduction to make from the profits of their business for the year 1891–92 (the year in which the commuted payment was made) and that if they had elected to continue the annual payment of £4,000 that amount would have been charged in their revenue account yearly, and so have reduced the profits assessable for taxation.

6. Mr. Edmund Watson, Appellant, the Surveyor of Taxes, on behalf of the Crown, on the other hand, contended that the sum of £55,846 8*s*. 5*d*. could not from the very nature of the case be considered an expense necessary to earn the profits of the year against the revenue of which it was sought to be charged, that being a payment at the option of the Royal Insurance Company it was in reality part of the consideration paid for the business of the Queen Insurance Company, and was therefore properly a charge to capital as an expense of acquiring the undertaking and not against revenue, that under the agreement already quoted the annual payment of £4,000 would have been for services rendered and a legitimate charge against profits so long only as the payment lasted, but that the commutation of this annual payment involved the abandonment of all claim to services and transformed the annual payment into a capital expense, and that, therefore, the deduction of £55,846 8*s*. 5*d*. from the profits of the year to 31st December 1891 was not

admissible in arriving at the liability of the Company for assessment under the provisions of the Income Tax Acts.

7. We, the Commissioners, on consideration of the foregoing facts, were of opinion that the sum of £55,846 8*s*. 5*d*., paid as aforesaid, was a proper deduction from the profits chargeable to Income Tax, and the Surveyor, having, on behalf of the Crown, expressed dissatisfaction with our decision as being erroneous in point of law, demanded a case for the opinion of the High Court of Justice in accordance with the Act 43 & 44 Vict. c. 19. s. 59, which we have hereby stated and signed accordingly.

The question for the opinion of the Court is whether or not for purposes of assessment to Income Tax, the Royal Insurance Company are entitled to charge against their profits the sum of £55,846 8*s*. 5*d*. paid by them in the year 1891–92 in commutation of the salary of £4,000 which would otherwise have been paid annually to Mr. J. K. Rumford, who was manager of the Queen Insurance Company at the time of its acquisition by the Royal Insurance Company.

HUGH PERKINS,
THOMAS BROCKLEBANK,
Commissioners.

Liverpool.

The case came before the Queen's Bench Division on the 23rd May, 1895, when, the Court differing in opinion, Wright, J., withdrew his judgment, and Vaughan Williams, J., whilst giving judgment against the Crown on the facts before the Court, ordered that the case stated by the Commissioners be remitted to them for amendment, in order to ascertain the circumstances under which, and the consideration in respect of which, the agreement to pay the sum of £55,846 8*s*. 5*d*. to the manager was arrived at.

An appeal by the Crown against this judgment was heard on the 19th November, 1895, when the Court of Appeal, consisting of Esher, M.R., Lopes, L.J., and Kay, L.J., reversed the order of the Court below, and gave judgment in favour of the Crown, with the costs in the Court of Appeal. Against this judgment the Company appealed to the House of Lords.

Joseph Walton, Q.C. (*W. H. Horsfall* and *Hyslop Maxwell* with him) for the Company :—This payment was an expense incurred in order to earn profits. The expenses allowable under Schedule D are not confined to those incurred in earning the profits of the particular year. In business, money must

necessarily be spent in one year, the benefits earned from such expenditure being reaped over a considerable length of time, *e.g.*, in advertising. This payment was for services required by the Appellants. Although it was part of the arrangement for the amalgamation of the businesses, it was not an expenditure of capital.

Sir R. B. Finlay, S.G. (*Sir R. E. Webster, A.G.* and *Danckwerts, Q.C.*, with him), for the Surveyor, were not called upon.

JUDGMENT

The Lord Chancellor.—My Lords, I have had some difficulty in dealing with the various grounds on which this case has been debated, both in the Court below and in the Court of Appeal; but there is one ground which practically is, to my mind, only a question of fact, and which I think is decisive of the issue in this Appeal. I desire to say that with reference to some other questions which I think will not be governed by this case, because, as I say, this case will turn on what I have previously described as more or less a question of fact, and if it had been necessary to enter into those other questions, I think we should have heard the Solicitor General, and applied our minds to the solution of some of the very difficult and intricate problems which are raised by the language of the Income Tax Acts; but, confining myself to the one ground upon which this case, I think, must depend, I entertain no doubt whatever that the Judgment of your Lordships ought to be in affirmation of the Judgment of the Court of Appeal.

My Lords, whatever else is clear in the Income Tax Acts, or obscure, there is no doubt about one particular head of inquiry which is to my mind decisive of this case. It is often a very difficult question to ascertain, in dealing with a commercial account, what is capital and what is income, but if it is established as a fact that the expenditure is capital the language of the statute itself determines that that expenditure cannot be deducted from the profits, and that the profits are to be ascertained without reference to the capital expenditure. That appears to me to be decisive of this case, because if I look at the whole circumstances of this transaction, and observe that the transfer from the one Company to the other is to be upon certain terms, which terms are before us upon the agreement sanctioned by the statute, I can entertain no doubt whatever that the money which was to be paid by the one Company, and which was the consideration for the transfer of the business from the one Company to the other, was capital expenditure in the hands of the new Company, who had received the business, the goodwill, and the staff, and all other accessories which made it possible to continue the business, and one of the items

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there is the particular matter which arises here. There was a manager, and the object was to have that manager brought within the new Company. It has been actually argued by the learned counsel, Mr. Walton himself, that it was very important indeed that the manager should be in communication with the agencies; that it was important for the Company that that man should still continue in connexion with the Company. Then an agreement is made not between the manager and the Company, there may have been another agreement, and of course there must have been, but the agreement before us is an agreement between the Vendor Company and the Vendee Company, and that agreement places upon the Vendee Company the obligation of taking this manager upon certain terms.

It is not necessary, as I say, to go into any other part of the question than this. Other questions undoubtedly would arise; the question of commutation and one or two other matters, which I decline to refer to, but this is perfectly clear; it may be said that the bargain between the two Companies involved a liability, which was discharged by the payment of this sum, and therefore I, as a matter of fact, come to the conclusion that this was a part of the purchase money (and when I use the compendious phrase " purchase money ", of course I include the arrangement made in respect of shares, because it matters not whether it was paid in money or was paid in money's worth), but the result is that one of the Companies sells to the other, and part of the consideration which was contemplated by both parties, and in respect of which the bargain was made, and without which the bargain could not have been made, was the manager, and all that was incident to the manager in respect of the payments to be made to him, whether made at once, or made in this form of commutation.

My Lords, under these circumstances it appears to me that this comes within the express language of the statute; it is capital expenditure, it is the purchase money for the concern, that is to say, it is partly so. It is perfectly immaterial whether it was entirely so, or partly so, because if it was partly so, it is enough to establish the proposition which I am maintaining.

My Lords, under these circumstances it appears to me it is unnecessary and undesirable to go into the other questions raised in this case. That one proposition satisfies me, and I hope will satisfy your Lordships, that this Appeal cannot be maintained; and therefore I move your Lordships that the Appeal be dismissed with costs.

Lord Herschell.—My Lords, I am of the same opinion. The question is whether this sum of between £50,000 and £60,000 paid to the former manager of the Queen Insurance Company, who afterwards became manager of the Appellant Company, can be set against the receipts of the year in which the payment was made for the purpose of arriving at the balance of the profits

(Lord Herschell)

or gains for that year. I am of opinion that it cannot. I think that, when the substance of the transaction is looked at, it really was a sum employed as capital in the adventure or concern. The payment was not made merely as the result of a contract of service with the former manager of the Queen Insurance Company. The payment was made in pursuance of a bargain entered into between the Royal Insurance Company and the Queen Insurance Company, which bargain contained the terms on which the Royal Insurance Company was to become possessed of the business of the Queen Insurance Company. Of course it could not be disputed for a moment that the price paid to a Company whose concern was bought by another Company, would not be expenditure which could be set against the gains of the year in which the payment was made. It would obviously be capital expenditure, and although, in this case, the payment was a payment to be made under that agreement to the former manager of the Queen Insurance Company, when the matter is looked at in its substance and essence, I do not think that payment differs from such a payment as I have alluded to. I think it was equally a payment made in pursuance of the obligation contained in the contract by which the business of the Queen Insurance Company was purchased, and therefore is properly capital expenditure.

My Lords, that is enough for the decision of the case, and I do not intend to express an opinion upon any other point, but, in consequence of observations which were made in the Court below, I desire to guard myself upon certain points and to state that I do not express an opinion upon them, but desire to leave myself perfectly free hereafter if they should arise.

To my mind the case is not necessarily the same as if this were a payment made to a person employed by the Company for the purpose of determining his service, getting rid of him and substituting somebody else in his place, quite apart from any such agreement as existed in the present case between the Royal Insurance Company and the Queen Insurance Company—a mere part of an arrangement made between the Company and one of their employees. In my opinion, this is not such a case. I desire to say nothing to prejudice the decision if such a case arose.

Again, the view has been expressed that no expenditure can be charged in any year, or in any one of the three years the average of which is taken, unless that expenditure can be shown to have been expenditure relating wholly to the earnings made in one of the three years or in each of them. That, again, is a point upon which I desire to leave myself entirely open to act as may seem fit after argument, if the question should arise. I base my judgment exclusively upon the point to which I have called attention.

Lord Macnaghten.—My Lords, I am of the same opinion. I think this payment was a payment on account of capital, and, being so, it cannot be

(Lord Macnaghten)

deducted. I also desire to make the same reservation as my noble and learned friend with regard to the other questions which have been mentioned.

Lord Shand.—My Lords, if this had been a case of a voluntary agreement between the manager of an insurance company and the company for the payment to him of a salary for so many years, to last for a definite time, but with power to the company, at any time they might think fit, to terminate the service by making the payment at once of a capital sum, I think there would have been much force in the argument that such a payment might properly form a deduction from gross profits in striking the balance liable to Income Tax, and I should make the same observation as to a case in which there has been wrongful dismissal of a person having an engagement for a term of years and who succeeds in obtaining damages on that account. But this case seems to me to be entirely different. I agree with your Lordships in thinking that in this question as to Income Tax the sum which is proposed to be deducted in striking the balance of the profits and gains was a payment of capital and must be debited to capital and not deducted from the income of the year. The Queen Insurance Company, in parting with their business, stipulated that they should have allocated amongst their shareholders a certain amount of new stock to be created. But they further stipulated that the Company purchasing their business should undertake a responsibility which, in the end, has resulted in the payment of £55,846 8*s.* 5*d.* We do not see what the motive was which induced them to make this stipulation. It may be that they were themselves bound to their manager under an agreement lasting for a period of time, and that they desired to get rid of that obligation, and have it transferred to the purchasing Company. It may be that they were so satisfied with his services that they desired to reward the manager who was leaving their employment. But however that may be, they did stipulate that there was to be a money advantage given to their manager on leaving their employment. That was, as it seems to me, clearly an obligation undertaken by the Royal Insurance Company to make a payment in consideration of acquiring the business of the Queen Insurance Company. That, my Lords, I think was a payment of capital, and, therefore, not a proper deduction from profits.

I desire to add, following upon what my noble and learned friend, Lord Herschell, has said, that for my part I should have very great doubts of the ground of judgment which I see has been stated by several of the learned Judges who have already considered this case, founded upon the view that expenditure which is made in one year must, if it is to be deducted for the purposes of Income Tax, have reference to profits made during that year.

(Lord Shand)

I should have very great difficulty indeed in adopting the reasoning on that subject which is to be found in the judgments in the Court below.

On these grounds, my Lords, I am of opinion, with your Lordships, that this judgment should be affirmed.

Lord Davey.—My Lords, I agree with your Lordships that the payment to the manager, which was in question in this Appeal, did, in fact, form part of the consideration for the purchase of the Queen Insurance Company's business and connexion, and that being so, the point is sufficient for the decision of the case. In these circumstances I do not find it necessary to say anything, and I say nothing upon the other points which have been opened to us, but which have not been fully argued before us.

Questions put.

That the judgment appealed from be reversed.

The non-contents have it.

That this Appeal be dismissed with costs.

The contents have it.