HIGH COURT OF JUSTICE (CHANCERY DIVISION)—20TH, 21ST AND 22ND NOVEMBER, AND 7TH DECEMBER, 1962

COURT OF APPEAL—13TH, 17TH, 18TH AND 19TH JUNE, AND 18TH JULY, 1963

HOUSE OF LORDS—14TH, 15TH AND 16TH APRIL, AND 4TH JUNE, 1964

F. S. Securities, Ltd.

v.

Commissioners of Inland Revenue(1)

Surtax—Undistributed income of company—Dividends received on securities dealt in by company—Whether company an investment company—Income Tax Act, 1952 (15 & 16 *Geo.* VI & 1 *Eliz.* II, *c.* 10), *Sections* 245 *and* 257(2).

The Appellant Company was incorporated in August, 1954, *and was at all material times under the control of not more than five persons. Its memorandum of association provided,* inter alia, *that it might purchase, hold and deal in shares, etc.*

In December, 1954, *and March,* 1955, *the Company purchased the entire share capital of three companies, each of which had substantial undistributed profits. On* 28*th March,* 1955, *all three companies declared large dividends. The value of their shares decreased as a result, and this decrease was reflected in the trading account of the Company for the period from* 1*st September,* 1954, *to* 31*st March,* 1955. *The Company claimed and was allowed relief under Section* 341, *Income Tax Act,* 1952, *in respect of a trading loss for that period on the basis that the dividends should be excluded in computing its trading profit or loss for tax purposes.*

On 22*nd January,* 1960, *a direction under Section* 245, *Income Tax Act,* 1952, *was given in respect of the Company's actual income from all sources for the above-mentioned period, on the footing that it was an investment company within the meaning of Section* 257(2). *On appeal, the direction was confirmed by the Special Commissioners.*

In the Court of Appeal and the House of Lords, the Company contended that the dividends declared on 28*th March,* 1955, *were, consistently with* Cenlon Finance Co., Ltd. *v.* Ellwood, 40 T.C. 176, *trading receipts to be taken into account in arriving at its liability under Case I of Schedule D.*

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

CASE

Stated under the Income Tax Act, 1952, Section 247(1) and Section 64, by the Commissioners for the Special Purposes of the Income Tax Acts for the opinion of the High Court of Justice.

1. At a meeting of the Commissioners for the Special Purposes of the Income Tax Acts (hereinafter referred to as " the Special Commissioners ")

(1) Reported (Ch.D.) [1963] 1 W.L.R. 173; 107 S.J. 135; [1963] 1 All E.R. 318 ; 234 L.T.Jo. 94; (C.A.) [1963] 1 W.L.R. 1223; 107 S.J. 850; [1963] 3 All E.R. 229; 234 L.T.Jo. 525; (H.L.) [1964] 1 W.L.R. 742; 108 S.J. 477; [1964] 2 All E.R. 691; 235 L.T.Jo. 372.

held on 17th November, 1960, and thence adjourned to 18th November, 1960, 31st January, 1st February and 20th March, 1961, F. S. Securities, Ltd. (hereinafter called "the Appellant"), appealed against a direction made by the Special Commissioners on 22nd January, 1960, on the footing that the Appellant was an investment company within the meaning of Section 257(2), Income Tax Act, 1952, to which the provisions of Section 245, Income Tax Act, 1952, applied, directing that for the purposes of assessment to Surtax the actual income of the Appellant from all sources for the period 1st September, 1954, to 31st March, 1955, should be deemed to be the income of the members of the Appellant. The grounds of the appeal were that the Appellant was not an investment company within the meaning of the said Section 257(2), Income Tax Act, 1952, and therefore the direction of the Special Commissioners was incorrect in law and ought to be discharged.

2. Evidence was given at the hearing of the appeal by Leonard Lever (hereinafter referred to as "Mr. Lever") a director of the Appellant from 1954 to 1959; May Lever (hereinafter referred to as "Mrs. Lever") the wife of Mr. Lever; Leslie Lavy (hereinafter referred to as "Mr. Lavy") a chartered accountant and a partner in the firm of Lavy Ascher & Co., chartered accountants, and a director of the Appellant from 1954 to 1959; and the following documents were produced and admitted or proved:

(i) Statutory declaration dated 13th May, 1949, made by Raymond George Harding Banbridge.

(ii) Memorandum and articles of association of the Appellant.

(iii) Settlement dated 1st January, 1955, between Reuben Lipman, Rita Lavy and Mr. Lavy.

(iv) Trading and profit and loss account of the Appellant for the period 1st September, 1954, to 31st March, 1955, and balance sheet at that date.

(v) A bundle of schedules comprising: (*a*) purchases and sales of securities and dividends received by the Appellant from 1st September, 1954, to 31st March, 1955, (*b*) interest and dividends received by the Appellant, and (*c*) securities held by the Appellant on 31st March, 1955.

(vi) Direction dated 22nd January, 1960, issued to the Appellant by the Special Commissioners.

(vii) Notice of apportionment dated 22nd January, 1960, issued to the Appellant by the Special Commissioners.

(viii) Notice of assessment to Surtax 1954–55 dated 22nd January, 1960, made on Mr. Lever by the Special Commissioners.

(ix) Notice of charge dated 22nd February, 1960, issued to the Appellant by the Special Commissioners.

(x) A bundle of accounts of the trustees of A. D. and P. J. Lever covering the period 1st April, 1953, to 5th June, 1960.

(xi) A bundle of accounts of the Lavy (children) trust covering the period 1st January, 1955, to 31st March, 1957.

(xii) Agreement dated 20th March, 1956, between Eastlandia, Ltd., Mr. Lever, Mrs. Lever, Mr. Lavy, and Rita Lavy.

(xiii) Minute book of the Appellant.

(xiv) Profit and loss account of the Appellant for the year to 31st March, 1956, and balance sheet at that date.

(xv) A letter dated 1st February, 1949, from J. H. Jarman to Mr. Lever.

(xvi) A bundle of correspondence.

(xvii) Income and expenditure account of Lavy (children) trust for the year to 31st March, 1958, and balance sheet at that date.

The above documents are not attached to and do not form part of this Case, except to the extent that they have been incorporated herein.

3. We found the following facts admitted or proved on the evidence adduced at the hearing of the appeal:

(1) The Appellant was incorporated on 19th August, 1954, with a share capital of £100 divided into 100 shares of £1 each, which were held as follows during the relevant period:

Mr. Lever and Mrs. Lever as trustees (as from 19th October, 1954.)	83
Mr. Lavy and Mrs. Lavy as trustees (as from 18th January, 1955.)	15
J. H. Howard (transferred to Mr. and Mrs. Lever, 4th February, 1955.)	1
J. D. Collinson (transferred to Mr. and Mrs. Lever, 4th February, 1955.)	1

The directors of the Appellant were Mr. Lever, Mr. Lavy and Mr. Yablon, and the Appellant carried on the business of a finance company.

(2) The memorandum of association of the Appellant contained, *inter alia*, the following objects for which the Appellant was established:

"To carry on the business or businesses of Stock and Share Dealers, and to purchase, subscribe for, acquire, hold and deal in shares, stocks, debentures, bonds, securities and obligations generally of any government, company, corporation or body; and to promote finance, advance money on hire purchase or otherwise assist any company or companies, whether corporate or unincorporate, or persons as may be thought fit; and to act as agents for the issue and placing of, and to underwrite shares, debentures and other securities or obligations."

(3) The trading and profit and loss accounts of the Appellant for the period 1st September, 1954, to 31st March, 1955, contained, *inter alia*, the following entries:

Trading and profit and loss account for the period 1st September, 1954, to 31st March, 1955

	£	s.	d.	£	s.	d.		£	s.	d.	£	s.	d.
To purchases of securities							By sales of securities				135,357	0	0
Quoted	166,208	5	0				Securities on hand—31st March, 1955						
Unquoted	1,317,565	1	7				Quoted	28,814	10	6			
				1,483,773	6	7	Unquoted	424,114	7	10			
											452,928	18	4
							Gross Loss carried down				895,487	8	3
				1,483,773	6	7					1,483,773	6	7
To gross loss brought down				895,487	8	3	By dividends received						
							Quoted securities (gross)	3,043	2				
							Unquoted securities (gross)	1,686,198	12	2			
											1,689,241	14	9

(4) The figures for purchases and sales, dividends received and securities on hand at 31st March, 1955, in respect of quoted securities were made up as follows:

Purchases and sales of securities and dividends received for the period 1st September, 1954 to 31st March, 1955

Date	Security	Purchase Price £ s. d.	Sale price £ s. d.	Net dividends received £ s. d.	Date received (1955)
1954					
31st December	£3,000 5½% Japanese Loan 1930	4,433 2 0		158 9 5	1st March
,,	£3,000 5% South Manchurian Railway Co. 1923 Loan ...	3,214 7 0		82 10 0	,,
,,	£8,000 6% Japanese Bonds 1924	7,782 17 6		264 0 0	31st January
1955					
7th January	£8,000 Roumanian 4% and 7% Monopoly Loans	5,140 16 0			
18th January	Colvilles, Ltd.				
	Application amount £8,750				
	Excess application £8,575	175 0 0			
25th January	Colvilles, Ltd.		249 5 6		
14th February	£11,000 5% Japanese Assented Bonds 1907	14,371 8 0			
,,	£3,000 Japanese 5½% Loan		4,135 13 0		
,,	£3,000 South Manchurian Railway Co. 1923 Loan ...		3,027 10 6		
,,	£8,000 6% Japanese Bonds 1924		7,354 4 0		
,,	£100,000 British Electricity 4¼% Guaranteed Stock ...	107,002 0 0			
15th February	£100,000 British Electricity 4¼% Guaranteed Stock—Ex dividend		105,373 0 0	1,168 15 0	26th March
23rd February	Stock purchased from Percy Phillips & Co. (Trading Stock)	415 0 0			
	Stock sold to A. E. Hinds		465 0 0		
7th March	£11,000 Japanese Assented Bonds 1907		14,752 7 0		
8th March	£11,000 Japanese Assented Bonds 1907—Ex dividend	14,218 18 0			
31st March	£10,000 3½% War Stock	8,632 5 0			
	1,000 4/- units British Land Co., Ltd.	822 11 6			
		£166,208 5 0	£135,357 0 0	£1,673 14 5	
				Gross equivalent £3,043 2 7	

Quoted securities on hand at 31st March, 1955

	£	s.	d.
£11,000 Japanese 5% 1907 Assented Bonds	14,218	18	0
£1,000 Roumanian External Loan	665	0	0
£7,000 Roumanian 7% Monopolies	4,475	16	0
£1,000 British Land Co., Ltd.	822	11	6
£10,000 3½% War Stock	8,632	5	0
	£28,814	10	6

(5) The figure of £1,317,565 for purchases of unquoted investments represented the cost to the Appellant of the undermentioned purchases of the entire share capital of three companies, i.e.:

10th December, 1954, B. & Co., Wool Merchants (Bradford), Ltd. £175,075;

3rd March, 1955, Cranwell (Holdings) Ltd. £732,823;

and, 25th March, 1955, N.E.T. Holdings, Ltd. £409,667.

To purchase these shares the Appellant arranged overdraft facilities with its bankers who agreed to, and did in fact, lend the Company 93 per cent. of the value of the shares which were lodged with them by way of security. As additional security the bank also took a charge over the cash assets of those companies the whole of whose shares were acquired by the Appellant. The assets of these three companies consisted almost entirely of liquid resources and each had substantial undistributed profits. The object of the directors of the Appellant in purchasing these shares was to carry out an operation colloquially known as "dividend-stripping", that is to say, to transfer to the Appellant by way of dividend the maximum amount of the undistributed profits of these companies, and then to use the resulting fall in the value of the shares of these companies as the basis of a loss claim under Section 341, Income Tax Act, 1952, so as to reclaim the tax deducted or deemed to have been deducted from the dividends declared and paid to the Appellant. These operations were duly carried out by the Appellant for each of the three companies mentioned above, and the dividends paid to the Appellant on 28th March, 1955, were as follows:

B. & Co. Wool Merchants (Bradford), Ltd. (net)	£33,523
Cranwell (Holdings), Ltd. (net) ...	£494,629
N.E.T. Holdings, Ltd. (net) ...	£399,256
Total	£927,408 (£1,686,198 gross)

The shares of the three "stripped" companies were retained by the Appellant for any ultimate purpose that the directors could put them to, their market value at 31st March, 1955, being estimated as follows:

B. & Co. Wool Merchants (Bradford), Ltd.	£146,769
Cranwell (Holdings), Ltd.	£252,345
N.E.T. Holdings), Ltd.	£25,000
Total	£424,114

(6) In due course the Appellant made a claim for repayment of tax under the provisions of Section 341, Income Tax Act, 1952, which was admitted in the sum of £404,020, of which £250,000 was repaid on 14th December, 1955, and £154,020 on 28th February, 1958.

(7) On 22nd January, 1960, the Special Commissioners issued a direction to the Appellant in the following terms:

"Whereas it appears to the Special Commissioners of Income Tax that F.S. Securities Ltd. (formerly Federated Securities Ltd.) is an investment company to which Section 245 of the Income Tax Act, 1952, applies, the Special Commissioners of Income Tax hereby give notice that they direct that for purposes of assessment to surtax, the actual income of the said company from all sources for the period from 1st September, 1954, to 31st March, 1955, shall be deemed to be the income of the members and the amount thereof shall be apportioned among the members.

If the company is aggrieved by this direction, it may appeal to the Special Commissioners by giving notice of appeal to their Clerk within thirty days from the date hereof.

Dated this 22nd day of January, 1960."

4. It was contended on behalf of the Appellant:

(i) that the Appellant was not an investment company within the meaning of Section 257(2), Income Tax Act, 1952, to which the provisions of Section 245, Income Tax Act, 1952, applied, and therefore the said direction dated 22nd January, 1960, of the Special Commissioners was incorrect in law; and

(ii) accordingly that the appeal should be allowed and the said direction discharged.

5. It was contended on behalf of the Respondents:

(i) that the Appellant was an investment company within the meaning of Section 257(2), Income Tax Act, 1952, to which the provisions of Section 245, Income Tax Act, 1952, applied, and that therefore the said direction dated 22nd January, 1960, of the Special Commissioners was correct in law;

(ii) that the appeal should be dismissed and the said direction confirmed.

6. We, the Commissioners who heard the appeal, having taken time to consider our decision, gave this in writing on 20th March, 1961, in the following terms (so far as is material to the present case):

The first question for our decision is therefore whether or not the Company is an investment company. The Company was incorporated in August, 1954, to carry on the business of a finance company, buying and selling stocks and shares, and this it did; and in our opinion, having regard to the decision in *J. P. Harrison (Watford), Ltd.* v. *Griffiths*[1] (High Court of Justice 2nd November, 1960, before Danckwerts, J.) there can be little doubt that it was a trading company. The real question is whether it also falls within the definition of an investment company within the meaning of Section 257(2), Income Tax Act, 1952. In the period covered by the aforementioned direction made by the Special Commissioners, the Company purchased, in particular, the share capital of three companies with the object of carrying out what has been called a "dividend-stripping" operation in each case. The result of these operations was that the Company's accounts made up to 31st March, 1955, showed a gross trading loss on the one hand amounting to £895,487 and dividends received from quoted securities £3,043 and unquoted securities £1,686,198—a total of £1,689,241—on the other. The Company made a claim under Section 341, Income Tax Act, 1952, which was duly admitted, for repayment in respect of the tax deducted from these dividends in relation to the trading loss. It is said that, although it was quite proper to compute the trading loss of the Company for the purposes

(1) 40 T.C. 281.

of Schedule D without including the dividends received by the Company, such dividends were nevertheless trading receipts of the Company's trade inasmuch as they satisfied the definition of earned income provided in Section 525(1)(*c*), i.e. they were " income which is charged under Schedule B or Schedule D and is immediately derived . . . from the carrying on or exercise of (the Company's) trade ". If this were correct the Company would not fall within the definition of investment company in Section 257(2) referred to above. We do not think that this argument is well-founded. On the authorities cited to us, in particular *Hughes* v. *Bank of New Zealand,* 21 T.C. 472, and *Cenlon Finance Co., Ltd.* v. *Elwood*(1), it seems to us that dividends cannot be charged to tax under Schedule B or Schedule D and cannot, therefore, be regarded as earned income within the terms of the definition contained in Section 525(1)(*c*). Moreover, the Company's primary object in purchasing the shares in the three companies subjected to the " dividend-stripping " operation was to obtain the dividends, i.e. the income arising from the shares, and not to deal in the shares themselves, which could only have been sold at a loss after the operations had been carried out and which in fact were never sold or otherwise disposed of. It seems to us that in these circumstances, apart from the question of law to which we have already referred, the nature of the income is more akin to investment income than to trading income. In our opinion the Company falls to be regarded as an investment company within the meaning of Section 257(2), Income Tax Act, 1952.

In the final result the direction of the Special Commissioners is confirmed.

7. Immediately after the determination of the appeal, dissatisfaction therewith as being erroneous in point of law was expressed to us on behalf of the Appellant, and in due course we were required to state a Case for the opinion of the High Court of Justice pursuant to the Income Tax Act, 1952, Section 247(1) and Section 64, which Case we have stated and do sign accordingly.

8. The question of law for the opinion of the High Court of Justice is whether, on the facts found by us as hereinbefore set forth, there was evidence upon which we could properly arrive at our decision, and whether on the facts so found our determination of the appeal was correct in law.

N. F. Rowe
N. S. Spendlow } Commissioners for the Special Purposes of the Income Tax Acts.

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

28th February, 1962.

The case came before Ungoed-Thomas, J., in the Chancery Division on 20th, 21st and 22nd November, 1962, when judgment was reserved. On 7th December, 1962, judgment was given against the Crown, with costs.

Mr. F. Heyworth Talbot, Q.C., and Mr. H. Major Allen appeared as Counsel for the Company, and Sir Frank Soskice, Q.C., Mr. E. Blanshard Stamp and Mr. Alan Orr for the Crown.

Ungoed-Thomas, J.—The question raised by this appeal is whether the Appellant Company, F.S. Securities, Ltd., was an investment company within the meaning of Section 257 (2) of the Income Tax Act, 1952.

(1) 40 T.C. 176.

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The Appellant was a Company controlled by not more than five persons in accordance with the requirements of Section 256 of that Act, and accordingly liable to a direction by the Special Commissioners under Section 245 that, for the purposes of assessment to Surtax, the actual income of the Company from all sources should be deemed to be the income of the members of the Company. The Special Commissioners, on 22nd January, 1960, made such a direction in respect of the Company's income for the period 1st September, 1954, to 31st March, 1955. This direction was made on the footing that the Appellant was an investment company within the meaning of Section 257 (2), and thus subject to more stringent provisions in the Act than would otherwise apply to it.

The objects in the Company's memorandum of association were those appropriate to a company dealing in shares ; and it carried on the business of a finance company buying and selling stocks and shares. During the period covered by the Special Commissioners' direction the Company bought the entire share capital of three companies for the total sum of £1,317,565, of which the following are the particulars: on 10th December, 1954, in respect of the first company, £175,075 ; on 3rd March, 1955, in respect of the second company, £732,823 ; and on 25th March, 1955, in respect of the third company, £409,667.

The Special Commissioners, in their findings of fact in the Case Stated, state as follows:

> " The assets of these three companies consisted almost entirely of liquid resources and each had substantial undistributed profits. The object of the directors of the Appellant in purchasing these shares was to carry out an operation colloquially known as 'dividend-stripping', that is to say, to transfer to the Appellant by way of dividend the maximum amount of the undistributed profits of these companies, and then to use the resulting fall in the value of the shares of these companies as the basis of a loss claim under Section 341, Income Tax Act, 1952, so as to reclaim the tax deducted or deemed to have been deducted from the dividends declared and paid to the Appellant. These operations were duly carried out by the Appellant for each of the three companies mentioned above, and the dividends paid to the Appellant on 28th March, 1955, were as follows ".

Then there is set out, in respect of the first company, the sum of £33,523 net ; in respect of the second company, £494,629 net ; in respect of the third company, £399,256 net ; making a total of £927,408 net, representing £1,686,198 gross.

The Cast Stated continues :

> " The shares of the three 'stripped' companies were retained by the Appellant for any ultimate purpose that the directors could put them to, their market value at 31st March, 1955, being estimated as follows ".

Then it sets out the figures, in respect of the first company, £146,769 ; in respect of the second company, £252,345 ; in respect of the third company, £25,000 ; making a total of £424,114. The Appellant Company's trading and profit and loss accounts for the period 1st September, 1954, to 31st March, 1955, being the period covered by the Special Commissioners' direction under Section 245, show (ignoring shillings and pence), on the debit side, under the heading " To purchases of securities ", the figure I have already mentioned, of £1,317,565 and a figure of £166,208 for other securities: and, on the credit side, in respect of sales of securities, £135,357 ; under the heading " Securities on hand ", the above figure of £424,114, and in respect of other securities the figure of £28,814. The deduction of the total on the credit side from the total on the debit side shows a gross loss of £895,487. These accounts also show, in respect of dividends, the above sum of £1,686,198 dividends gross ; and,

(Ungoed-Thomas, J.)

from other securities, dividends amounting to £3,043 gross. The operations in respect of these three companies thus constituted by far the main part of the Appellant Company's operations during the period covered by the direction. Independently of any recovery of tax, the dividend-stripping transaction showed a profit of over £30,000. In due course the Appellant Company made a claim for repayment of tax under the provisions of Section 341 of the Income Tax Act, 1952, in respect of deductions made for tax from the £1,686,198 dividends from the three companies, and £404,020 was accordingly repaid, of which £250,000 was repaid on 14th December, 1955, and £154,020 on 28th February, 1958.

The terms of the Special Commissioners' decision, set out in the Case Stated, contain the following passages:

> " In our opinion, having regard to the decision in *J. P. Harrison (Watford), Ltd.* v. *Griffiths*(1) (High Court of Justice, 2nd November, 1960, before Danckwerts, J.)

—pausing there, that case eventually went up to the House of Lords, and the decision of Danckwerts, J., was in substance confirmed—

> " there can be little doubt that it was a trading company. The real question is whether it also falls within the definition of an investment company within the meaning of Section 257 (2), Income Tax Act, 1952. In the period covered by the aforementioned direction made by the Special Commissioners the Company purchased, in particular, the share capital of three companies with the object of carrying out what has been called a ' dividend-stripping ' operation in each case."

Then, later, it says:

> " On the authorities cited to us, in particular *Hughes* v. *Bank of New Zealand*, 21 T.C. 472, and *Cenlon Finance Co., Ltd.* v. *Elwood*(2),"

—pausing there, at this time the *Cenlon* case had been decided in the Chancery Division, but that decision was later reversed by the Court of Appeal, which was upheld in the House of Lords—

> " it seems to us that dividends cannot be charged to tax under Schedule B or Schedule D and cannot, therefore, be regarded as earned income within the terms of the definition contained in Section 525 (1) (*c*). Moreover, the Company's primary object in purchasing the shares in the three companies subjected to the ' dividend-stripping ' operation was to obtain the dividends, i.e., the income arising from the shares, and not to deal in the shares themselves, which could only have been sold at a loss after the operations had been carried out and which in fact were never sold or otherwise disposed of. It seems to us that in these circumstances, apart from the question of law to which we have already referred, the nature of the income is more akin to investment income than to trading income."

I turn, then, to the Sections of the Act referred to in the Case Stated. Section 257 (1) reads as follows:

> " The preceding provisions, of this Chapter shall, in relation to companies which are investment companies, have effect subject to the subsequent provisions of this Chapter."

The preceding provisions referred to include special provisions with regard to investment companies to which a Section 245 direction is given. Sub-section (2) reads:

> " In this section, and in the subsequent provisions of this Chapter, ' investment company ' means a company the income whereof consists mainly of investment income, and ' investment income ' means, in relation to a company, income which, if the company were an individual, would not be earned income ".

Then there follows a proviso with which we are not concerned. Section 525, so far as relevant, reads, in Sub-section (1):

> " Subject to the provisions of subsection (2) of this section, in this Act, ' earned income ' means, in relation to any individual . . . (*c*) any income which

(1) 40 T.C. 281. (2) 40 T.C. 176.

(Ungoed-Thomas, J.)

is charged under Schedule B or Schedule D and is immediately derived by the individual from the carrying on or exercise by him of his trade ",

and the rest of that paragraph I need not read.

In this case, if the dividends obtained by the Company by the dividend-stripping operation were investment income, the Company would, at the relevant period, be a company " the income whereof consists mainly of investment income ", and therefore an investment company. The question in this case therefore becomes: does the Company's income consist mainly of such income, as determined by the dividends obtained from the dividend-stripping operation, as would be, if the Company were an individual, income which is both (*a*) income which is charged under Schedule D and (*b*) is immediately derived by the individual from the carrying on, or exercise by him, of his trade? If not, then the Company is an investment company.

First it would be convenient to consider (*b*), namely, whether the Company's income consists mainly of such income as would be, if the Company were an individual, income immediately derived by the individual from the carrying on, or exercise by him, of his trade. The Company was a trading company carrying on the trade of dealing in shares. Were these dividends part of the income derived from carrying on that trade? The Special Commissioners concluded that they were not, and the reason for that conclusion is contained in the last passage which I have read from the Case Stated. In that passage, the determining factor in reaching that conclusion appears to be that —and I quote—

" the . . . primary object in purchasing the shares . . . subjected to the ' dividend-stripping ' operation was to obtain the dividends . . . and not to deal in the shares themselves ".

It was conceded that the dividends there referred to were not dividends in general over a period of time but the dividends to be obtained by one swoop in the stripping operation. If the true view of that object and its achievement was that it was trading in shares, it seems to me clear that the Special Commissioners would and should have come to a different conclusion.

Sir Frank Soskice, however, emphasised that the Company never disposed of the shares, and their value after stripping was shown, presumably correctly, in the Company's accounts at a substantial figure—namely, £424,000. He added that, although the repayment of tax by the Revenue was on the footing that the shares were stock-in-trade and not investments, yet their decision was made in 1955 and without appreciating that the shares would be retained so long. On the other hand, however, the Case Stated makes it clear that the assets of the three companies—and I quote—" consisted almost entirely of liquid resources " ; and, further, that the object of the purchaser was to carry out the " dividend-stripping ". The persuasive considerations which Sir Frank urged do not change my view that, if the obtaining of the dividends as part of the dividend-stripping operation was a trading in shares, then the Special Commissioners would and should have come to a different conclusion.

In *Griffiths* v. *J. P. Harrison* (*Watford*), *Ltd.*(1), [1962] 2 W.L.R. 909, a dividend-stripping operation was held to be a trading transaction. In that case the shares were sold after the stripping was carried out, whereas here they were retained—and I quote—" for any ultimate purpose that the directors could put them to ". In that case, however, there was only one such transaction, whereas here there were three. In that case there was practically no profit apart from the recovery of tax, whereas here there was a profit of over £30,000. In that case there was no other dealing in shares during the relevant

(1) 40 T.C. 281.

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period, whereas here the Company carried on a substantial business as dealers in shares without taking into account the three dividend-stripping transactions. At page 913([1]), Viscount Simonds, in concluding that the transaction was a trading transaction, stated:

> " . . . a dealer may seek his profit, if a profit is essential, otherwise than by an enhanced price upon a resale, as by a declaration of dividend, a repayment upon a reduction of capital or upon a liquidation of the company whose shares he has bought ; "

and Pearce, L.J., in arriving at the same conclusion as the House of Lords, said that:

> " dividends may be properly regarded for normal purposes as part of the receipts of a dealer in shares([2])."

It seems to me that, where the primary object of a transaction is to obtain the dividends, as in this case, by one swoop as part of a dividend-stripping operation, the dividends are not of the nature of investment income at all. The rights which the shares represent are substantially realised, with a consequent substantial writing-down of the value of the shares. This is merely a method of turning the shares, to a large extent, into cash and profit as part of the trade of dealing in shares. The Special Commissioners, in my view, wrongly thought that, because the primary object was to obtain the dividends and not to deal in the shares themselves, it followed that the income was of a nature of investment income rather than trading income—a misconception which led to a conclusion which it does not seem to me can be reasonably maintained.

I come now to the other question, namely (*a*), whether the Company's income consists mainly of such income as would be, if the Company were an individual, income which is charged under Schedule D. It is well established that dividends as such are not charged to Income Tax, but in *Cenlon Finance Co., Ltd.* v. *Elwood*([3]), [1962] 2 W.L.R. 871, it was held, in the circumstances of that case, that dividends were nevertheless trading receipts of the company which received them, and should therefore be included in the computation of trading profits for purposes of taxation under Schedule D. Sir Frank urges, first, that the principle on which the *Cenlon* case was decided does not apply where tax has been deducted in respect of the dividends ; and, secondly, that, even if it did so apply, the dividends would not be income charged under Schedule D within Section 525. I will consider these submissions successively.

Although it is well established that dividends as such are not charged to Income Tax, the reasons for this conclusion are obscure and afford no sure guide to solving the problem whether dividends in respect of which tax has been deducted should enter into the computation of a trader's profits. The provision that dividends as such are not charged to Income Tax, however, clearly does not, in view of the *Cenlon* decision, require that dividends should, in virtue of their being dividends, be excluded from the computation of a trader's profits—because otherwise the exclusion would apply to the dividends in the *Cenlon* case. Why, then, should they be excluded or included, and does the *Cenlon* case assist in the case of dividends in respect of which tax has been deducted? It seems to me that the principle underlying the *Cenlon* decision is that the dividends were received as a trading receipt ; but a dividend does not cease to be a trading receipt because Income Tax has been deducted in respect of it ; and, subject to any provision to the contrary, it follows that it enters into the computation of the trader's profit charged under Case I of Schedule D by Sections 122 and 123 of the Income Tax Act, 1952. It appears that the only statutory provision to the contrary which

([1]) 40 T.C., at pp. 293–4. ([2]) *Ibid.*, at p. 288. ([3]) 40 T.C. 176.

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might except such a dividend from the computation is Section 184; but all that Section does is to give the distributing company the option, when it is charged to tax on its profits, to deduct tax at the standard rate. The amount of dividend which is distributed, whether without such deduction or after such deduction, is a receipt of the recipient's trade.

The position is thus stated in *Purdie* v. *The King,* [1914] 3 K.B. 112, at page 116, by Rowlatt, J.:

> "The company, therefore, is assessed and pays the tax. There is, strictly speaking, no tax upon dividends at all; the company has to pay income tax upon its profits as a company, and, having paid the income tax, the effect is that there is less to divide among the shareholders. Sometimes a company declares what it calls a dividend 'free of income tax', which means that having paid income tax the dividend paid is less because there is less to divide. Sometimes it declares a dividend which it does not call free of income tax, and then it deducts a certain percentage from the dividend, stating that it is for income tax. The real effect of the latter course is, not that the company has declared a dividend of the full amount and then deducted income tax from it, but that it has declared a dividend of the net amount and told the shareholders that it would have been so much more but for the fact that the profits of the company were charged with income tax before the dividend was made. Strictly speaking, therefore, the suppliant has not been charged with income tax at all in respect of her interest and dividends. The charge is imposed upon the agents who pay the interest"

—pausing there, that is a reference in that case to the payment of interest on foreign bonds through agents in this country, and therefore may be ignored in the case with which we are concerned—

> "and upon the company which pays the dividends, and the agents and the company have to pay the amount of the income tax to the Crown in respect of that charge."

Viscount Simon, in *Canadian Eagle Oil Co., Ltd.* v. *The King*[1], [1946] A.C. 119, quoting Lord Russell of Killowen, says at page 139:

> "And Lord Russell of Killowen[2], looking at the matter from a different angle, said 'that while the amount which [the company] could have deducted as the "tax appropriate thereto" has been definitely fixed at the standard rate for the year in which the amount of the dividend became due, it is in no way comparable with the tax payable by the company itself.'"

There is good equitable reason for avoiding double taxation, or, more accurately, adjusting the tax in respect of any amount deducted by the distributing company, so as to ensure that the taxpayer does not bear any additional burden in respect of tax by reason of the deduction. But that does not appear to me to justify excluding the dividends from the computation of profits for tax purposes. It is essentially a problem of adjustment only. Donovan, L.J., in the *Cenlon* case[3], [1961] Ch. 634, at page 653, considered that such dividends

> "would fall to be included in a computation of profits taxable under Case I of Schedule D, with an adjustment of the tax bill which allows for that suffered at source."

That passage was referred to with approval by Viscount Simonds[4] and Lord Denning[5] on appeal. As was emphasised before me, it was an *obiter dictum.* Not only, however, is such a statement to be regarded with the greatest respect, but it seems to me, for the reasons I have given, to be the conclusion which follows from the principle underlying the *Cenlon* case decision.

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(1) 27 T.C. 205, at p. 248. (2) Commissioners of Inland Revenue *v.* Cull, 22 T.C. 603, at p. 640. (3) 40 T.C. 176, at p. 198. (4) *Ibid.*, at p. 203. (5) *Ibid.*, at p. 207.

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Mr. Heyworth Talbot was so good as to bring to my notice Section 428 of the Income Tax Act, 1952. That Section substantially repeats Section 13 of the Finance Act, 1937, which makes a special provision bringing income from investments of life insurance funds into account. He suggested that it might be argued from these provisions, against himself, that dividends should not, in the absence of a special provision, be brought into an account of a trader's profits. These Sections themselves, however, do not so provide. They afford grounds for distinction from the present case ; and the argument was not relied on by the Crown. Also, it seems to me that such an argument would be as inconsistent with the *Cenlon* decision(1) itself as it would be with the view I have expressed in this case on the underlying principle of the *Cenlon* decision.

I come now to Sir Frank Soskice's submission that, even though the principle of the *Cenlon* decision applies to dividends in respect of which tax has been deducted, yet they would not be income which is charged under Schedule D. As items entering into the computation of the trading profits of the recipient, the dividends would not themselves be liable to Income Tax as separate items. Sir Frank argues that, for this reason, the requirement of Section 525 that the income is charged under Schedule D is not satisfied. This calls for an examination of Sections 257 and 525. What is required to qualify as an investment company under Section 257 in conjunction with Section 525 is that the company should be—and I quote from the Sections, omitting irrelevant words—

> " a company whereof the income consists mainly of . . . income which if the company were an individual would not be . . . income which is charged under Schedule D ".

In accordance with my conclusion that the dividends in this case formed part of the Company's trading income, that trading income is, in the circumstances, the Company's main income. There is no requirement that the dividends, any more than the other separate items of income which constitute the trading income, should be separately charged under Schedule D. The charge under Schedule D is, in the words of Section 122, and as far as material here, on " the annual profits or gains arising or accruing . . . from any trade ". There is no " income which is charged under Schedule D " except in the sense of either being or of entering into the computation of " the annual profits or gains ". In either sense the Company's main income is trading income which is charged to Schedule D. In my view, this is income " which is charged under Schedule D " within the meaning of Section 525.

Further, it is argued that the dividends would, if the Company were an individual, enter into computation for Surtax. " Surtax ", however, is only the term used to describe the amount of Income Tax payable by an individual in excess of the amount which would have been payable if Income Tax had been chargeable at the standard rate only. It is Income Tax. Mr. Heyworth Talbot submits that, as part of Income Tax, it could only be charged under the Schedules, which would, if this Company were an individual, be Schedule D ; and that therefore, even if the dividends should not be treated as part of the trading receipts for the purposes of calculating tax at the standard rate, it nevertheless would form part of the income charged under Schedule D. I am not aware of any substantial answer to this submission.

It may be convenient if I add some observations on the further alternative submissions made by Mr. Heyworth Talbot, and on which I have

(1) 40 T.C. 176.

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had the advantage of hearing argument, though they do not affect my decision. On the requirement that the income should be charged under Schedule D, he submitted that the dividends themselves are income charged under Schedule D because they are distributions of income so charged in the hands of the company effecting the distributions. It seems to me, however, on the construction of Section 525, that the income which " is charged " under Schedule D is income so charged in the hands of the recipient, and that the optional deduction from the dividends by the paying company in respect of Income Tax does not constitute a charge of tax on the gross dividends at all. Mr. Heyworth Talbot however suggested that the required charge was satisfied by the charge on the company's profits in the company's hands out of which the dividends were paid. He referred to the statement of Lord Phillimore in *Bradbury* v. *English Sewing Cotton Co., Ltd.,* 8 T.C. 481, at pages 518–9, that for Income Tax purposes the shareholders of a company are treated as quasi-partners, so that payment of Income Tax by the company would discharge the shareholders. This passage, however, was the subject of criticism in the *Cenlon* case(1), and in any case it does not, in my view, do more than give some historical explanation of the avoidance by the Revenue of what would in effect be double or increased taxation. The passage does not establish that the charge on the company's profits is a charge on the shareholder's income or dividends. Mr. Heyworth Talbot also relied in the *Cenlon* case(2), [1961] Ch. 634, at page 653, where Donovan, L.J., said that dividends are not assessed to Income Tax because

> " while a company is one person and its shareholder is another, nevertheless no new fund of profit is created merely by dividing that fund."

That again seems to me to be by way of explanation why the double taxation which I have mentioned is not exacted by taxing dividends. None of these passages appears to me to impinge upon those passages which I quoted earlier from Rowlatt, J.'s judgment(3) and Viscount Simon's speech(4), and which make it clear that the charge on the company's profits cannot be considered a charge on the dividends. This alternative submission should not, therefore, in my view, prevail. But, for the reasons which I have stated before referring to this further alternative submission, the Appellant Company is, in my judgment, entitled to succeed on the appeal.

Mr. H. Major Allen.—Your Lordship allows the appeal with costs? And I take it, my Lord, that the direction will be discharged?

Mr. Alan Orr.—I agree that is the right Order, my Lord.

Ungoed-Thomas, J.—Very well: Order accordingly.

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(1) 40 T.C. 176. (2) *Ibid.*, at p. 197.
(3) Purdie *v.* The King, [1914] 3 K.B. 112, at p. 116.
(4) Canadian Eagle Oil Co., Ltd. *v.* The King, 27 T.C. 205, at p. 248.

The Crown having appealed against the above decision, the case came before the Court of Appeal (Sellers, Donovan and Russell, L.JJ.) on 13th, 17th, 18th and 19th June, 1963, when judgment was reserved. On 18th July, 1963, judgment was given unanimously against the Crown, with costs.

Sir Frank Soskice, Q.C., Mr. Alan Orr, Q.C., Mr. E. Blanshard Stamp, and Mr. J. Raymond Phillips appeared as Counsel for the Crown, and Mr. F. Heyworth Talbot, Q.C., and Mr. H. Major Allen for the Company.

Sellers, L.J.—I have have the advantage of considering the judgment which Donovan, L.J., has prepared and is about to deliver, in which he has set out the facts and referred to the authorities relied on in the respective arguments. I agree with his judgment and the conclusion that the appeal should be dismissed. I would only add this briefly.

F.S. Securities, Ltd., in so far as it traded at all, and it must be accepted that it did, traded in stocks and shares, and the three securities in question which it held were the main part of its stock-in-trade (*J. P. Harrison (Watford), Ltd.* v. *Griffiths,* 40 T.C. 292). The Company claimed to have made a loss and was regarded by the Inland Revenue so to have done and was paid over £400,000 as a repayment of tax on that basis, but as its trade brought in earnings of over £1,600,000 gross dividends received, the Company in fact made a fabulous profit on £100 subscribed capital. If the facts are to be accepted as establishing a " trading " or any loss, a more fictitious or home-made loss it would be hard to devise in business affairs.

As the shares of the three companies which F.S. Securities, Ltd., acquired, and with which it traded, were its stock in trade producing trade earnings, the same shares were not a separate source producing an investment income, and without that income being established as investment income the Respondent Company cannot be held to be an investment company however desirable it would be that such transactions as were carried out by or on behalf of the few members of the Company should make their contribution, by means of taxation, to the requirements of the country's revenue. Enrichment without any service to the community and without taxation is hard to countenance.

Donovan, L.J.—This is an appeal by the Commissioners of Inland Revenue from a decision of Ungoed-Thomas, J., given in favour of the taxpayer, F.S. Securities, Ltd.

Against that Company the Special Commissioners of Income Tax had made a direction under the provisions of the Income Tax Acts dealing with the under-distribution of dividends by a limited company with consequent avoidance of Surtax by the shareholders.

In 1936 the Legislature, stung to action by the continued ingenuity of the taxpayer and his advisers in avoiding Surtax by means of the incorporation of a company and the withholding of dividends, passed legislation which in effect divided such companies into two categories: (1) trading companies and (2) companies which Parliament labelled " investment companies ". The trading company would continue to be liable to Surtax on its profits only if it had failed to distribute a reasonable part thereof, having regard to its requirements for the maintenance and development of the business. The " investment company ", on the other hand, was to be subject to certain limitations in this respect. Then in 1939 it was enacted

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that an " investment company " should be liable to Surtax on all its profits however much or however little it had distributed by way of dividend. This legislation has now been codified in the Income Tax Act, 1952, see Chapter III thereof comprising Sections 245 to 264 inclusive. In this field, therefore, it is advantageous to be a trading company and disadvantageous, as a rule, to be an investment company.

The Legislature originally defined an " investment company " by Section 20 of the Finance Act, 1936. The like definition is now contained in Section 257(2) of the Income Tax Act, 1952. I had better quote it in full:

> " In this section, and in the subsequent provisions of this Chapter, ' investment company ' means a company the income whereof consists mainly of investment income, and ' investment income ' means, in relation to a company, income which, if the company were an individual would not be earned income ".

The Special Commissioners in the present case were dealing with the income of the Company for the period 1st September, 1954, to 31st March, 1955. They took the view that the income of the Company consisted during this period mainly of investment income as defined by Section 257(2) ; and they accordingly made a direction upon the Company which, if valid, has the effect, when coupled with an apportionment of that income among the Company's members, that a large sum of Surtax becomes payable to the Crown. The Company appealed to the Special Commissioners against this direction, arguing that it was a trading company and not an investment company. This argument failed before the Special Commissioners, but succeeded before Ungoed-Thomas, J.

The Court is here concerned with a dividend-stripping operation. The Company was incorporated on 19th August, 1954, with a capital of £100, and 83 per cent. of the capital was held by two persons jointly. The memorandum of association proclaimed that one of the objects of the Company was to carry on the business of stock and share dealers. On 10th December, 1954, the Company purchased the entire share capital of B. & Co., Wool Merchants (Bradford), Ltd. On 3rd March, 1955, it purchased the entire share capital of Cranwell (Holdings), Ltd., and, on 25th March, 1955, the entire shareholding of N.E.T. Holdings, Ltd. These purchases cost altogether £1,317,565, and one might well ask where this £100 Company got the money from. The answer is that, as to 93 per cent. of it, it came from the Company's bankers on loan.

These three companies were, as the saying goes, " full of dividend "—that is, of undistributed profit represented by liquid resources—and the advantage of these purchases to their shareholders was that they thus obtained the equivalent of these undistributed profits as tax free capital. The advantage to the Respondent Company was that it could, as the law then stood and as the practice of the Revenue then was, recover a very large sum of Income Tax. This was achieved as follows. The Respondent Company caused dividends to be paid to it by the three companies whose shares it had acquired, the total of such dividends being £927,408 after deduction of Income Tax at the standard rate, the equivalent gross amount being £1,686,198. The market value of the shares in the three companies naturally dropped as a result, and on 31st March, 1955, their market value was estimated at £424,114, a figure which is not disputed. Since the Company had bought them for £1,317,565, the difference was £893,451. The Company claimed that this difference was a loss sustained in the trade of dealing in

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shares, and that under Section 341 of the Income Tax Act, 1952, it was accordingly entitled to receive back from the Inland Revenue the Income Tax deducted at source from the dividends totalling £1,686,198 (gross) declared by its three subsidiary companies. The repayment would be limited under that Section to a sum equivalent to Income Tax on a figure of £895,487, the alleged trading loss; that is, the aforesaid £893,451 plus a small loss on other stocks and shares. Even so, the tax reclaimed would amount to £404,020. The Inland Revenue admitted the claim and paid this sum. The cash receipts of the Company up to this point were thus as follows: dividends (net), £927,408; repayment of tax, £404,020, totalling £1,331,428. The Company still had the shares of the three subsidiary companies valued at £424,114, and this gives a total of assets of £1,755,542. Deducting the sum of £1,317,565 required to buy the shares in the three subsidiary companies in the first place, the profit was £437,977, all made by a company with a subscribed capital of only £100. This is subject, of course, to the interest paid to the bank for borrowed money which was, however, a comparatively small sum.

The question now arises: was this Company, for the period in question—that is, 1st September, 1954, to 31st March, 1955 (its first accounting period)—an investment company under Section 257(2)? This depends on whether its income during this period was mainly " investment income " and this depends in turn on whether its income was mainly income which, had the Company been an individual, would not have been earned income. Earned income is defined by Section 525 of the Income Tax Act, 1952, and the part of that definition here relevant is that contained in Section 525(1) (*c*), namely:

> " any income which is charged under Schedule B or Schedule D and is immediately derived by the individual from the carrying on or exercise by him of his trade . . .".

One has to assume, therefore, that the Company is an individual, and an individual trading in stocks and shares. On that assumption the question is whether these dividends totalling £1,686,198 gross were income charged under Schedule B or D and were they immediately derived from the carrying on of a trade? If so, they will be earned income and the Company will not be an " investment company ". If not, they will not be earned income and the Company will be an investment company.

The argument on this narrow question of construction has travelled over a wide field, but I need do no more than summarise it. For the Crown it is contended that dividends declared by a company resident in the United Kingdom are not, as such, charged to Income Tax whether under Schedule D or any other Schedule. This proposition rests on the authority of a lengthening line of cases beginning with *Purdie* v. *The King*(1), and ending for the moment with *Cenlon Finance Co., Ltd.* v. *Ellwood*(2); and it is not disputed. Then it is said that, while according to the views expressed in the last mentioned decision, dividends received under deduction of Income Tax by a trader in stocks and shares would form part of his trading receipts and thus enter into the computation of his trading profits, this of itself does not involve the consequence that the dividends thereby become " charged under Schedule D ". For what is charged under that Schedule is the balance emerging when expenses have been put against receipts. For the Company it is contended that, pursuant to what was said in the *Cenlon* decision, these dividends are trading receipts. They must, therefore, be brought into the computation of

(1) [1914] 3 K.B. 112. (2) 40 T.C. 176.

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trading profits, albeit some allowance will have to be made eventually for the tax suffered by deduction. Since they have to be brought into this computation, they are " charged under Schedule D " within the meaning of Section 525(1)(*c*) of the 1952 Act.

The *Cenlon* case([1]) concerned what is colloquially known as a " capital dividend "; that is, one paid out of non-taxable profits of the distributing company. The company could not, therefore, deduct Income Tax at source, and the recipient shareholder—that is, the Cenlon company—was not liable to Income Tax on the dividend as such. But that company traded in stocks and shares, and the Inland Revenue, exercising the privilege of changing its mind, eventually contended that the dividend must therefore be brought into the computation of the company's trading profits, although originally the Revenue had acquiesced in the company's contrary view. During the argument of the case in this Court it was said for the company that dividends taxed at source were not brought into the computation of profit made by a dealer in stocks and shares, so why should a dividend not so taxed be brought in? Deduction or non-deduction of tax was, it was argued, an immaterial consideration. The answer given was that dividends taxed at source ought to be brought into such a computation. Strictly speaking, of course, this was *obiter*, but it would have been unsatisfactory not to deal with the point thus raised. In the House of Lords, Viscount Simonds and Lord Denning expressed the same view: and accordingly even if, on reflection, I thought I had been mistaken in what I myself said in this Court, I would certainly defer to their view. But I see no reason to depart from what I said. Viscount Simonds did say, however, that it had always been the practice of the Revenue to include taxed dividends in the computation of a share dealer's profits for the purpose of assessment. This apparently was not so, see *Rex* v. *Commissioners of Income Tax for City of London*, 91 L.T. 94. This would not be the first time, however, where Revenue practice and the law parted company. I say this in no spirit of criticism. This is a difficult code to administer, and practical considerations no doubt justify at times some departure from strict law, for the common convenience of the Revenue and the taxpayer.

In my opinion one must take it to be the case that in law the dividends taxed at source with which we are here concerned should, if they were receipts of the Company's trade in dealing in stocks and shares, have entered into the computation of the profits of that trade. I entertain no doubt that these dividends were part of the Company's trading receipts. No other view is reasonably open on the facts, though one must say a little more on this aspect of the matter later.

Under Schedule D the calculation of the trading profit which is to be taxed necessarily involves an arithmetical exercise in which expenses will be set against receipts. Does this involve that the receipts are " charged under Schedule D "? Originally, at any rate, this was the root question in the case. Section 1 of the Income Tax Act, 1952, provides that where any Act enacts that Income Tax shall be charged for any year, then the tax

> " shall be charged for that year in respect of all property, profits or gains respectively described or comprised in the Schedules ".

In relation to Schedule D, Section 122 of the Act provides, so far as is here material, that tax shall be charged under Schedule D in respect of

> " the annual profits or gains arising or accruing . . . to any person residing in the United Kingdom from any trade . . . whether carried on in the United Kingdom or elsewhere ",

([1]) 40 T.C. 176.

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and the wording of the charge concludes,

> " in each case for every twenty shillings of the annual amount of the profits or gains ".

Section 127 enacts that tax shall be charged under Cases I and II of Schedule D " on the full amount of the profits or gains . . .". Case I, of course, is the Case under which trading profits are taxed. There are numerous other Sections which follow, all using the expression " profits or gains " as the subject matter of the charge to tax, for example, Sections 128, 129, 130, 136, 137 and so on. This, of course, is not surprising. One pays tax on trading profits, not on trading receipts, and one would expect the charge to be a charge on " profits or gains ". Furthermore, on occasions when Parliament has intended to refer to the receipts of a trade as distinct from the profits of the trade, it has said so in quite clear terms. Thus, Section 342(4) of the Act refers to

> " any interest or dividends on investments . . . which would fall to be taken into account as trading receipts in computing the profits or gains of the trade for the purpose of assessment under that Case "

—that is, Case I; and Section 4 of the Finance (No. 2) Act, 1955, the provision which ended the attraction of dividend-stripping, enacts, in Subsection (1), so far as is here material, that

> " the net amount of the dividend received on the shares shall . . . be brought into account in computing the profits or gains or losses of the trade . . .".

So far, therefore, there seems to be no support for the view that trading receipts as such are " charged under Schedule D ". Mr. Talbot, however, contends that if it were not so, then the decision in the House of Lords in *Hughes* v. *Bank of New Zealand*[1], [1938] A.C. 366, would have had to be the opposite of what it was.

The Bank of New Zealand was a non-resident company carrying on business at a branch office in London. As part of the assets of that branch it held some 5 per cent. War Loan and some India Government stock, securities of the Grand Pacific Railway and securities of the Auckland Electric Power Board, and on these various holdings it received interest. The War Loan had been issued by the Treasury, with a condition that the interest should be exempt from all taxation in the hands of a beneficial holder not ordinarily resident in the United Kingdom, and Section 46 of the Income Tax Act, 1918, gave statutory effect to this exemption. The other three securities qualified for a similar exemption, under Schedule C as regards the India Government stock, and under Miscellaneous Rule 7 of Schedule D as regards the remaining two securities. The Crown's argument was that the exemption from tax was confined to the interest as such, and not to any profits or gains of the trade of which the interest formed part of the receipts. For some reason they abandoned this argument in the House of Lords as regards the War Loan interest, but maintained it as regards the interest on the other securities. The House rejected it, on the ground that exemption from tax meant what it said and that even as a component part of the profits of a trade all the interest was exempt. It does not, in my judgment, necessarily follow from this decision that in the opinion of the House of Lords the interest, regarded as gross receipts of the company's trade, was charged under Schedule D and escaped tax by reason only of the exemption. The House did not need to decide that question one way or the other. On the view they took, it was enough to say that the interest was exempt from all taxation, and it did not matter how it was charged.

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(1) 21 T.C. 472.

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In the *Cenlon* case([1]) a similar argument was raised. It was said " This dividend is not charged to tax. If it is treated as part of the profits of the trade, it will be taxed, and thus the freedom from tax will be lost. This is contrary to the decision in *Hughes* v. *Bank of New Zealand*([2]) ". Again the argument did not succeed. Nothing in that case, in my opinion, compels us to the conclusion that the dividends in the present case must be taken to be " charged under Schedule D ".

Mr. Talbot also referred to, and relied upon, certain observations of a general character made by Lord Dunedin in *Whitney* v. *Commissioners of Inland Revenue*([3]), [1926] A.C. 37, a case deciding that non-residents were liable to Super-tax on income arising here. At page 52 of the report, Lord Dunedin said([4]):

> " My Lords, I shall now permit myself a general observation. Once that it is fixed that there is liability, it is antecedently highly improbable that the statute should not go on to make that liability effective. A statute is designed to be workable, and the interpretation thereof by a Court should be to secure that object, unless crucial omission or clear direction makes that end unattainable. Now, there are three stages in the imposition of a tax: there is the declaration of liability, that is the part of the statute which determines what persons in respect of what property are liable. Next, there is the assessment. Liability does not depend upon assessment. That ex hypothesi, has already been fixed. But assessment particularizes the exact sum which a person liable has to pay. Lastly, come the methods of recovery, if the person taxed does not voluntarily pay."

I am afraid I do not see how this passage helps in the present case. The declaration of liability we have to consider is that made by the Statute in the shape of Schedule D. The question is, however, on what is liability imposed, and that, it seems to me, must be decided by construing the language of the Act, and in particular Schedule D, itself.

A further argument by Mr. Talbot, which he submitted as an alternative, was this. He began by posing the question : " Why are dividends in the hands of an individual liable to Surtax at all as part of his total income?", and the answer he gave was this. Income tax is levied by Section 1 of the Income Tax Act, 1952, on profits and gains arising under the specified Schedules. The same must be true of Surtax, which the Legislature declares to be Income Tax at an additional rate. So that one pays Surtax on income charged to Income Tax and nothing else, and there is no provision specifically imposing a charge to Surtax on dividends or saying that dividends must be included for Surtax purposes in an individual's total income. So that if Surtax is imposed on income charged to Income Tax and on nothing else, and if dividends as such are not liable to Income Tax, how does Surtax become chargeable on dividends at all? The answer he suggested was that the Legislature does not regard dividends as a new income for Income Tax purposes but simply as part of a fund which has already been charged to Income Tax in the hands of the company paying the dividend. Thus it is right to say that the dividends here in question have been " charged to tax under Schedule D ", and the definition of earned income in Section 525 is so far satisfied.

This is an engaging argument, but I do not think it is right. The reason suggested why dividends are liable to Surtax may be sound enough, but we have to get back to the meaning of the words " charged under . . . Schedule D " appearing in Section 525. There is nothing in that Section, in my opinion, which justifies tracing back the history of a dividend until one can find it forming part of trading profits. How far back would one be entitled to go?

([1]) 40 T.C. 176. ([2]) 21 T.C. 472. ([3]) 10 T.C. 88. ([4]) *Ibid.*, at p. 110.

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There might be one or more holding companies interposed between the trading company and the individual who ultimately receives, via the holding companies, a share of the trading company's profits, but no machinery is provided for finding this out, or dealing with such a situation. Then again, the words of Section 525 defining earned income include the words

> "and is immediately derived by the individual from the carrying on or exercise by him of his trade".

These words clearly point to income derived by the individual as a trader himself, and not merely as a shareholder in a trading company, so that the preceding words, "charged under . . . Schedule D", would seem to connote a charge on the individual himself. Furthermore, if Mr. Talbot is right, an extraordinary difference would result for present purposes between a company whose income consisted of dividends from a fund of profits charged in some other company's hands under Schedule D and a company whose income consisted of dividends from a fund of profits charged in some other company's hands under Schedule C. The latter company would be an investment company while the former would not, a distinction for which there would be no rhyme or reason. Accordingly, I reject this alternative argument. I should add that in any event the Court does not know that the dividends now being considered came out of trading profits taxed under Schedule D in the hands of the three subsidiary companies or any of them. There is no finding in the Case one way or the other. Mr. Major Allen also submitted, for additional reasons, that the words "charged under . . . Schedule D" ought to be regarded as satisfied in the case of dividends, if those dividends were derived from shares in a trading company and were a distribution of its trading profits. I have already given my reasons for taking a contrary view, and need not repeat them.

So far, my conclusion would be that looking at these dividends by themselves it could not be said that they were charged under Schedule D; that they were therefore not earned income; that consequently under Section 257(2) of the Act they were "investment" income; and that, since they were the main part of the Company's income for the period in question, the Company was for that period an investment company. I am not sure that on this particular aspect of the case I am really differing from the learned Judge. He said that the charge under Schedule D was on the annual profits or gains from the trade, and commented(1):

> "There is no 'income which is charged under Schedule D' except in the sense of either being or entering into the computation of 'the annual profits or gains'. In either sense the Company's main income is trading income which is charged to Schedule D."

Only if the last sentence means that, in the Judge's view, gross receipts of a trade are "charged" merely by being brought into the computation of trading profit, would I venture with respect to disagree.

On this aspect of the case attention may usefully be drawn to certain provisions in Chapter III of Part IX of the Act of 1952. Section 245 refers to a company which has not distributed a reasonable part of its "actual income from all sources". Section 250 requires a company on request by the Special Commissioners to deliver to them, *inter alia,* a statement of the "actual income of the company from all sources". Section 255(3) requires that such income "shall be estimated in accordance with the provisions of this Act relating to the computation of income from that source".

In *F.P.H. Finance Trust, Ltd.* v. *Commissioners of Inland Revenue,* 26 T.C. 131, the House of Lords, construing the expression now reproduced in

(1) *See* p. 678, *ante.*

(Donovan, L.J.)

Section 257(2), namely, " a company the income whereof consists mainly of investment income ", held that the words " the income whereof " meant the actual income from all sources computed as for Income Tax ; and in the recent case of *C.H.W. (Huddersfield), Ltd.* v. *Commissioners of Inland Revenue*(1), Lord Hodson said that " The relevant income is not the income from day to day but the Income Tax income when ascertained ", and he quoted the remark of Lord Atkin in *Thomas Fattorini (Lancashire), Ltd.* v. *Commissioners of Inland Revenue,* 24 T.C. 328, at page 352, that

> " Actual income does not mean the specific receipts that come in from time to time, but the ' Income Tax income ' as calculated at the end of the year of assessment."

Lord Pearce said the same thing, and these observations support the views I have so far expressed.

At the end of the argument for the Respondent, however, Mr. Major Allen raised another point. Consistently with the decision in the *Cenlon* case(2), all the dividends received by the Company in the period under consideration must, he said, be considered as part of the receipts of the Company's trade in dealing in stocks and shares. When these are brought into the computation of the profits of that trade, the result is to produce a trading profit. The figures are : dividends received from quoted securities, £3,043 ; from unquoted securities (that is, the " stripped " shares), £1,686,198, totalling £1,689,241. Deduct the trading loss of £895,487, and the balance of profit is £793,754. That figure, which I will call a round £800,000, is the figure of profit from the Company's trading and is the only income of the Company. Since it is entirely trading income, the Company cannot be an investment company within the statutory definition.

There is no trace of any such contention as this in the Stated Case, and we were informed that the point was not taken, either before the Special Commissioners or before the learned Judge, and in fairness to both of them this should be stated. No doubt before the Special Commissioners the parties were not in possession of the Court of Appeal's decision in the *Cenlon* case. That decision was given on 1st May, 1961. The last hearing before the Special Commissioners was apparently on 1st February, 1961, when they reserved their decision and gave it on 20th March, 1961. In this they were able to refer to the *Cenlon* decision, but only on the point regarding the non-chargeability to Income Tax of dividends as such. Cross, J., had so decided in that case, but had gone further and said that the dividend in question in that case could not be included in the computation of Cenlon's trading profits from dealing in stocks and shares. On this latter point his decision was subsequently reversed. Nevertheless, the point could have been taken before Ungoed-Thomas, J., who heard the case on three days in the latter part of November, 1962, and gave judgment on 7th December, 1962.

A certain hesitation on the part of the Company to take the point is understandable. It had represented to the Revenue that for the period in question it had made not a trading profit of £800,000, but a trading loss of £895,000, and on that footing had recovered from the public purse a sum of no less than £404,020. The present point involves the Company in contending that this was all wrong and that, under the repayment Section of the Income Tax Act, 1952, Section 341, which it had invoked, nothing was repayable to the Company at all. Before us, the Crown raised no question of estoppel, nor did they object to this point now being raised. In all the circumstances the

(1) *See* p. 92, *ante.* (2) 40 T.C. 176.

(Donovan, L.J.)

Court decided to admit it, treating the argument simply as another facet of the Company's contention that it had no " investment income ".

The answer given to the point by Sir Frank Soskice was this. Conceding that upon a true view of the relevant law the Company must be considered as having made a trading profit in the period of £800,000, it is proper to go on and dissect that profit to see whether it contains any investment income. When the dissection is performed here, it is found that it contains £1,689,241 of investment income. He says that this is the result of applying Section 257(2) and is consonant with Lord Simon's speech in *F.P.H. Finance Trust, Ltd.* v. *Commissioners of Inland Revenue*(1).

As I have said, Section 257(2) defines an investment company as a company " the income whereof consists mainly of investment income ", and the Crown here argue that the word " consists " justifies the dissection or analysis of the Company's trading profit to find out whether it " consists " to any extent of investment income.

In *F.P.H. Finance Trust, Ltd.* v. *Commissioners of Inland Revenue,* the House of Lords decided that the words " the income whereof " appearing in the provision which was the predecessor of Section 257(2) meant the total income of the company from all sources, and it was with that total income that such part of it as consisted of investment income had to be compared to see whether the company was an investment company. For the period in question F.P.H. Finance Trust, Ltd., a company trading in stocks and shares before it went into liquidation on 1st April, 1938, had made a trading loss, but this loss was, conformably with the practice then obtaining, calculated without taking into account dividends received. Curiously enough, before the House of Lords the company sought to raise for the first time the point that these dividends were trading income and therefore earned income, but was not allowed to do so at that stage. In the last 15 months before liquidation, the company's receipts from dividends were more than counter-balanced by its trading losses, and it was therefore argued by the company that it had no " total income from all sources " for that period. It had none at all. This view was upheld. Lord Simon said that one should not first compute the trading income and then compare the investment income with the trading income. One had to compare investment income with the total income of the company from all sources. This was important where there was a trading loss which exceeded the investment income, for then the company's income was nothing. In this I can find nothing to support the Crown's contention in the present case that one must first ascertain the total income of the Company and then, even if that total income be found to consist entirely of trading profit, go on to analyse that trading profit to see whether dividends contributed towards it and, if so, in what measure. The House of Lords was not considering that point at all, and indeed would not allow the point to be taken in the House for the first time that the dividends were trading receipts. The situation before the House was, therefore, simply the case of a company with a trading loss but also with income from investments, that income not being treated as trading income. I cannot, as I say, find support for the Crown's present contention in that decision.

So far as the intrinsic merits of the argument are concerned, of course it follows from Section 257(2) that once you have found what the total income of the company is, you must find out whether that total income " consists " to any, and if so to what, extent of investment income. For example, if

(1) 26 T.C. 131.

(Donovan, L.J.)

one finds that a company has both trading profit and income from investments comprised in its total income, one must sort out the investment income and compare it with the amount of the total income. But this is a very different thing from saying that once you have found what the trading income is, you can then further analyse *that* income, to see whether dividends have contributed to it. In the present case the Company's trading income computed in accordance with the *Cenlon*(1) decision was, as I say, £800,000 and this was its total income. That being so, the Company cannot be an investment company, unless it is permissible to dissect that admitted trading income to see whether it has been computed by including dividends as trading receipts, and then treating such receipts to that extent as " investment income ". Such dividends have become part of the trading profit which is " earned income " within the definition contained in Section 257(2). They are not, for the purposes of the inquiry, one thing one moment and another thing the next. To my mind this new point allowed to be taken by the Company is conclusive of the appeal in its favour.

In the concluding part of their decision, the Commissioners refer to the Company's primary object in purchasing the shares in the three " stripped " companies as being to obtain the dividends and not to deal in the shares themselves, which would thereafter only be sold at a loss and which in fact have so far been retained. The Commissioners go on to say that in those circumstances the nature of the income from the shares " is more akin to investment income than to trading income ". This seems to be a rather tentative way of saying that the shares in question were not held as part of the Company's trade in dealing in stocks and shares, but as investments outside that trade. But there is no specific finding to that effect, and it is not consistent with the finding in the Case that the whole object of the Company in acquiring the shares was to carry out a " dividend-stripping " operation, which object necessarily involved that the shares should be part of the Company's trading stock.

Furthermore, at the outset of their decision the Commissioners find that the Company carried on a trade of buying and selling stocks and shares, without distinguishing in this respect any particular stocks and shares of the companies as being outside the ambit of this trade. In any event, even had the Commissioners found specifically that the shares in these three companies were not part of its trading stock, I do not see how such a decision could have stood, having regard to the evidence, and to the decision of the House of Lords in *J. P. Harrison (Watford), Ltd.* v. *Griffiths*(2). Sir Frank Soskice, however, has reserved the point.

I reach the conclusion, therefore, that the appeal must be dismissed. Subject to any time limit that may be applicable, the Special Commissioners presumably remain free to consider the Company's position as regards Surtax on the footing that for the period in question it had a trading income of some £800,000.

Russell, L.J.—I also agree, for the reasons given by Donovan, L.J., that the appeal should be dismissed, but in connection with the reference by Sellers, L.J., to enrichment without service and without taxation, I am quite ready to countenance a substantial sweepstake win, provided the winning ticket is mine.

Mr. H. Major Allen.—The appeal will be dismissed with costs?

(1) 40 T.C. 176. (2) 40 T.C. 281.

Sellers, L.J.—Yes. That is right, Mr. Phillips?

Mr. J. Raymond Phillips.—Yes, my Lord, subject to this, I do not know whether your Lordships, on the question of costs, might consider it relevant that this matter, on which, in effect, my friend has succeeded, only arose at the last moment. I mention it in case your Lordship considers it is relevant.

Sellers, L.J.—I doubt if it would have made any difference. You would have appealed in any case.

Mr. Phillips.—Yes, I admit that.

Sellers, L.J.—No. Dismissed with costs.

Mr. Phillips.—I am instructed in this case to ask for leave to appeal to the House of Lords.

Sellers, L.J.—Yes, we give you leave.

The Crown having appealed against the above decision, the case came before the House of Lords (Viscount Radcliffe and Lords Reid, Hodson, Guest and Upjohn) on 14th, 15th and 16th April, 1964, when judgment was reserved. On 4th June, 1964, judgment was given unanimously in favour of the Crown, with costs.

Mr. Alan Orr, Q.C., Mr. E. Blanshard Stamp and Mr. J. Raymond Phillips appeared as Counsel for the Crown, and Mr. F. Heyworth Talbot, Q.C., and Mr. H. Major Allen for the Company.

Lord Reid.—My Lords, the Respondent Company was incorporated in August, 1954, with a capital of 100 £1 shares. At the relevant period 83 of these shares were held by two persons as trustees. The main object of the Company was to carry on the business of stock and share dealers. Its most important venture was to purchase in December, 1954, and March, 1955, the entire share capital of three companies for sums amounting in all to £1,317,565. It financed these purchases by borrowing from its bankers 93 per cent. of the value of these shares. These three companies held large amounts of accumulated profits which had borne tax, and soon after purchasing them the Respondent caused them to declare dividends amounting to £927,408 net after deduction of tax or £1,686,198 gross.

The Respondent then prepared a profit and loss account for Income Tax purposes for the period from 1st September, 1954, to 31st March, 1955. This showed a loss of £895,487. This loss was arrived at by putting on the one side of the account the purchase price of the securities and on the other side the value of these securities after the dividends had been paid, leaving out of the account the dividends which were paid to the Respondent. The Respondent then submitted a claim under Section 341 of the Income Tax Act, 1952, for " repayment " of tax, and repayments were made in due course amounting in all to £404,020. It is found as a fact in the Case Stated that the object of the Respondent in purchasing these shares was to carry out an operation colloquially known as " dividend stripping ". All this was done in accordance with the practice which prevailed before Parliament took action to stop this kind of operation.

(Lord Reid)

The present case has arisen out of a direction given by the Special Commissioners in 1960 on the footing that the Respondent Company was an investment company within the meaning of Section 257(2) of the 1952 Act. This direction was to the effect that the income of the Respondent Company should be deemed to be the income of its members. The Respondent appealed on the ground that it was not an investment company. The Special Commissioners held that it was, and stated a Case. The Respondent succeeded before Ungoed-Thomas, J., and the Court of Appeal, and the Crown now appeal to this House.

Section 257(2) provides that:

> "'investment company' means a company the income whereof consists mainly of investment income, and 'investment income' means, in relation to a company, income which, if the company were an individual, would not be earned income".

"Earned income" is defined by Section 525, and the relevant part of the definition is:

> "(1) . . .(*c*) any income which is charged under Schedule B or Schedule D and is immediately derived by the individual from the carrying on or exercise by him of his trade, profession or vocation . . .".

It is now common ground between the parties that this case depends on how these large dividends ought to have been treated in making up the Respondent's profit and loss account under Schedule D, Case I. The Crown say that the method which was in fact followed was correct and that the dividends were properly left out of that account. If that is right, then it is not now disputed that these dividends were investment income, that the Respondent was an investment Company, and that the Special Commissioners' direction was properly given. But the Respondent now says that these dividends ought not to have been excluded from the profit and loss account and that therefore a properly framed account would have shown no loss. Counsel for the Respondent agrees that if his contention is right the Respondent ought not to have been repaid anything under Section 341 but the Respondent has not offered to repay the sum of £404,020.

So the question now in issue is the question how a dealer in stocks and shares ought to treat dividends accruing to him from shares which he has bought in the course of his trade. It was decided in *Cenlon Finance Co., Ltd.* v. *Ellwood,* 40 T.C. 176, that a capital dividend which is not paid under deduction of Income Tax must enter his profit and loss account and the Respondent maintains that the same rule must apply to dividends paid under deduction of tax.

The question how dividends paid under deduction of tax fall to be treated for Income Tax purposes has a long history. I dealt with that matter in my speech in the *Cenlon* case, but anything said in that case about dividends paid under deduction of tax was *obiter* because the question before this House related solely to dividends which had not borne tax, and I certainly did not have in mind any case like the present. So I have carefully reconsidered what I said in that case, but on reflection I see no reason to alter it. I said, at page 205[1]:

> ". . . I find it necessary to start from the ordinary case of a dividend paid out of profits under deduction of tax. Why is the shareholder not taxed on what he receives? It is part of his income, or if he is a trader, it is a trading receipt. But it seems always to have been recognised that an individual does not pay Income Tax on it (I do not refer to Surtax), and a trader does not include it as a trading receipt in determining his taxable profits."

(1) 40 T.C.

(Lord Reid)

But the view of Viscount Simonds and, to some extent, that of Lord Denning were different. In the ordinary case it would make no practical difference which view is right, but in this case if Viscount Simonds's view were right it would support the Respondent's argument. He said, at page 203(1):

> "... I would affirm what was said by Donovan, L.J. (than whom no one has a wider knowledge of revenue law), about the treatment by a trading company of dividends from which tax has been deducted at the source. There is no doubt that the practice is, and, so far as I know, always has been, to include such dividends in the computation of profits taxable under Case I of Schedule D and to make an allowance or adjustment for the tax that has been paid."

I do not think that Donovan, L.J., went quite so far as that, because he does not state what the practice was; he only said, at page 198(1):

> "These also, in my view, would fall to be included in a computation of profits taxable under Case I of Schedule D, with an adjustment of the tax bill which allows for that suffered at source."

It is now agreed by Counsel for both parties that there never was such a practice as that to which Viscount Simonds refers. At one time there was a somewhat similar practice with regard to claims based on losses, but as regards the ordinary profit and loss account to show the profits or gains chargeable under Schedule D, Case I, it was always the practice before the *Cenlon* case(2) for a trader to leave out of the account those trading receipts which consisted of dividends received by him after deduction of tax. The Respondent now says that the practice has always been wrong. In my opinion, it was right.

Neither view can be derived directly from any provisions of the Income Tax Act. If the words of the Act were applied literally the result would be double taxation of the same income, but it has been said again and again that the Act cannot be so read as to authorise that. If the Respondent's view is right, it is necessary to bring in some form of equitable adjustment after the assessable profit has been determined. Let me suppose that a trader in stocks and shares has received £5,000 net in dividends which have borne tax. The Respondent's Counsel concedes that in order to make his scheme work it is necessary to bring in not the net sum which the trader actually received but the gross amount of the dividends. If the standard rate were 10*s*. in the pound, the gross amount would be £10,000 and it is that sum which the Respondent says must be brought into the account. Then suppose that apart from such dividends the trader has made a profit of £4,000. On the Respondent's view, the profit and loss account will show a profit of £14,000 and tax on that at such standard rate would be £7,000. But that would plainly involve double taxation of the same dividends. He would have suffered deduction at source of £5,000 and he would have to pay another £5,000 by reason of the gross dividends having swollen his profit and loss account. So the Respondent says that the trader must be entitled to deduct from the £7,000 tax assessed under Schedule D, Case I, the sum of £5,000 which has already been deducted as tax before he receives the dividend. That would reduce the tax payable under Schedule D to £2,000, but there is no statutory warrant whatever for making that deduction.

If the Crown's view is right the proper procedure is much simpler. In the case I have supposed, the trader would simply leave the dividends out of his profit and loss account, which would then show a profit of £4,000, and

(1) 40 T.C. (2) *Ibid*., p. 176.

(Lord Reid)

he would pay £2,000 on that profit, so if there is a profit apart from the dividends it makes no difference which view is adopted. But it does make a difference if, apart from the dividends, the trader's operations show a loss. How great a difference that can be is shown by the present case.

Your Lordships must now choose between those two methods without any authoritative guidance. I have no hesitation in preferring the Crown's method, for a number of reasons. In the first place, it is in accord with long-standing practice and it has never been challenged: the matter was only considered incidentally in the *Cenlon* case([1]), and I do not think that it was the subject of any detailed argument. Secondly, it is much simpler and more direct. Thirdly, it avoids the fiction of having to regard the trader's trading receipts as including not only the net dividends which he actually receives but also the tax deducted by the company paying the dividends which the trader never did or could receive. And, fourthly, it appears to me to carry out more reasonably the principle that money once taxed cannot again be subjected to Income Tax. It appears to me more reasonable to say that dividends which have already borne tax shall not be brought into any further Income Tax calculation than to say, as the Respondent does, that they can be brought in so as to swell the assessment of profits under Schedule D, Case I, but that then there shall be an abatement not authorised by the Act.

I can find nothing to recommend the Respondent's method. It seems to be true that if it had been adopted earlier it would have prevented the abuse of dividend stripping. But the fact that it never seems to have occurred to the highly skilled advisers of the Crown to try to combat the abuse in that way is sufficient in itself to make me look on the method with great suspicion. Instead of trying to adopt it, Parliament had to be asked to pass complicated legislation on the assumption that the method then in use was correct.

If these dividends do not even enter into the computation of the Respondent's profits for the purposes of Schedule D, they are plainly not charged under Schedule D and are, therefore, not earned income within the meaning of Section 525. But then it cannot be denied that they were income of the Respondent, and they were by far the largest part of its income. If they were not earned income then they must come within the definition of investment income in Section 257. It follows that the Respondent was an investment company within the meaning of that Section and that the only ground of appeal against the decision of the Special Commissioners fails. I am therefore, of opinion that this appeal must be allowed and that the question of law in the Case Stated should be answered in the affirmative.

Viscount Radcliffe.—My Lords, there is only one issue in this appeal, whether the Respondent Company is an " investment company " within the meaning of Section 257 of the Income Tax Act, 1952. If it is, a direction issued to it on 22nd January, 1960, by the Special Commissioners of Income Tax, requiring that for purposes of Surtax assessment its actual income from all sources for the period 1st September, 1954, to 31st March, 1955, should be deemed to be the income of its members, is a valid direction: if it is not, the direction is made on a wrong basis. It suits the Respondent, or at any rate it suits its members, to maintain at this stage that in the period in question its income is to be regarded as that of a trading company.

([1]) 40 T.C. 176.

(Viscount Radcliffe)

The definition of an " investment company " is provided by the Statute and it is made for the purpose of implementing the part of it that deals with Surtax directions. By Section 257 (2) an " investment company " is declared to be one the income of which consists mainly of investment income, and " investment income " is income which, if the company were an individual, would not be earned income. It is not necessary to pause here upon the general question whether a financier, such as the Respondent is, would ordinarily be regarded as earning the dividends which may be declared upon the shares held by him for the purpose of his profit-making operations, for by Section 525 of the Act, " earned income " is defined as being

> " (1) . . . (*c*) any income which is charged under Schedule B or Schedule D and is immediately derived by the individual from the carrying on or exercise by him of his trade, profession or vocation ".

It is plain therefore that in these special Sections about Surtax directions the Legislature has adopted the ordinary distinction between investment income and earned income that belongs to the tax code.

What was, then, the Respondent's income for the relevant period, and could it rightly be described as earned income in the sense that it was charged under Schedule D and immediately derived from the exercise of its trade? It had, or must be credited with, a trade, since the Special Commissioners have so found, and its business can be described as that of a finance company. Actually, its main operations during the period consisted in buying, on a loan conveniently supplied by its bankers, unquoted investments representing the entire share capital of three limited companies which, no less conveniently, were " full of dividend ". The Respondent, which had a share capital of £100, was thus enabled to spend £1,317,565 in buying these blocks of shares, and, having bought them, to pay itself in cash dividends to the total amount of £927,408 out of the resources of the three companies. This sum, if grossed up at the standard rate of dividend current for the year, represented £1,686,198. The operation left the shares much reduced in value, and, as they were still held by the Respondent at 31st March, 1955, they were entered in its trading account as an item of stock in hand at a market value of £424,114 in all. The Respondent treated itself as having suffered a trading loss for the period to the amount of £895,487, almost entirely made up of the loss on these three items, and put in a claim to the Inland Revenue under Section 341 of the Act on the basis that, having suffered this loss in its trading income account, it was entitled to relief *pro tanto* from the tax that had been taken by deduction from the dividends on its three blocks of investments. The dividends, the £927,408, had not been entered, either net or gross, in the account of its trading income. Had they been, there would have been no loss and no claim for repayment of tax under Section 341.

The claim for loss relief was admitted in accordance with the current practice, and a sum of £404,020 representing tax on the £895,487, was repaid to the Respondent by two payments, one in December, 1955, and the other in February, 1958.

The argument on which the Respondent relies in its opposition to the Surtax direction that has been served upon it is in direct conflict with this course of proceeding. What it now maintains is that, as a trader in stocks and shares, it had no income during the relevant period that was not properly assessable under Case I of Schedule D as the profit of its trade.

(Viscount Radcliffe)

This would mean that the interest and dividends which it received, which are, to put it neutrally, the income yield on its investments, ought to be treated as mere items to the credit of its trading account and entered there accordingly; with the result that all its receipts were trading receipts and the "raw material" for a Case I assessment. From this it follows, it is said, that there was no investment income at all within the meaning of the Act, and the direction received was illegal.

Even if I accepted the argument itself, which I certainly do not, I am far from thinking that I should necessarily accept the conclusion. It seems to me that, if a taxpayer chooses to set out to prove that the Income Tax code is so constructed as to provide for one set of income receipts being taxed twice over under two separate categories of taxable income, he may conceivably succeed in this unusual undertaking: but if he does, it does not at all follow that the consequences of his having these two separate forms of taxable income can be ignored. Thus, in the present case, the Respondent has not the less received and suffered deduction of tax upon income from its three investments amounting to £1,686,198 gross, £927,408 net, because, according to it, those sums, gross or net, ought also to enter into its trading account and to contribute again to its assessable trading profit under Case I of Schedule D, a profit which, on the assumption made, would amount to a figure of some £800,000 instead of the supposed loss of £895,487. Unless there is something in the argument (there is nothing in the Act) to obliterate the fact that the Respondent had suffered tax on these dividends, it would still be true to say of it that in the half year its income consisted mainly of investment income. However, I do not pursue this and the kind of absurdity to which it gives rise, because I think that the argument itself is ill-founded and is the prime author of what would be an absurd result. Since, however, the argument has found favour with the Court of Appeal owing, I think, to a mistaken application of a recent decision of this House in *Cenlon Finance Co., Ltd.* v. *Ellwood,* 40 T.C. 176, I must now address myself to it.

We have, then, to suppose that the Respondent, instead of being a limited company, was operating its finance company business as an individual and carrying out the same operations as have been carried out here. If one were asked the bare question whether in making up the trading account of such a man it would be right to bring in interest and dividends received on the stocks and shares that he was dealing in, I should think that the answer would certainly be Yes. In principle it seems to be the way to arrive at a full and fair statement of his profit or loss. Whether there is a case for grossing up the sums received so as to write into the accounts the Income Tax deducted on payment, I am not at all clear. It looks like importing into the account, which, *ex hypothesi,* is being drawn up for general purposes and not those of Income Tax assessment, a conception which really belongs to the working of the Income Tax system and the peculiarities that it engenders. But that point is not material for the present purpose. What is material is to find out whether the theoretical method of composing the trading account, which I have just supposed, can possibly be adhered to, so far as interest and dividends are concerned, when the same individual has to strike the balance of his profits or gains for assessment under Case I of Schedule D of the Income Tax Act.

This enquiry cannot be conducted without restating the position of dividends as a subject of charge to Income Tax. I think that in this case one can confine oneself to dividends since it is the dividends of the three

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" stripped " companies that are the substance of the matter, but it has also to be noticed that some of the receipts which, it is said, ought to be included in the Case I assessment, were interest on British Government securities from which the paying agent had deducted Income Tax on payment, as required by Schedule C. Theoretically, I agree, there is no difference between the argument for including such interest and the argument for including dividends which are not dealt with by that Schedule. It is only that in practice a claim to include Schedule C interest would be rather more directly in conflict with established authority. I will therefore confine myself to dividends.

Dividends are sometimes spoken of as being exempt from assessment to Income Tax or as if they were somehow entitled to special protection under the tax system. There are, too, rather mysterious statements to the effect that they are not taxable " as such ". This is quite misleading and tends to create the idea that there is a special mystique about the taxation of dividends, an idea that in at least one respect has led to unfortunate consequences. In my opinion, there is by now really no room for doubt that dividends, for Income Tax as well as Surtax, are just as much a taxable subject as any other form of income, or for doubting that, for the purposes of Income Tax as distinct from Surtax, when they are distributed by a limited company out of a fund of profit that has been taxed in its hands, the proportionate shares of the taxed fund so distributed are not liable to taxation again in the hands of the recipients. The operation of transferring the residue of the taxed fund from the company's hands to the hands of the owners no more creates a fresh accrual of income than does the operation of a trustee paying over to his beneficiary the net amount of the trust income that has borne tax in his hands. Dividends which represent the distribution of a taxed fund are therefore " franked " income so far as concerns any further taxation at the standard rate, that is the rate at which deduction has been made; while, for the purposes of administering reliefs against tax at standard rate and of assessing to Surtax, it is proper to treat the net sum received as grossed up in the way that the Statute (Income Tax Act, 1952, Section 184) requires. This account of the status of dividends in the tax system is in line with the analysis offered by Lord Phillimore in *Bradbury* v. *The English Sewing Cotton Co., Ltd.*, 8 T.C. 481, at pages 518-9, where he points out that the Income Tax Act, 1842, the basic instrument of our Income Tax code, treated a joint stock company is if it were

> " a large partnership, so that the payment of Income Tax by a company would discharge the quasi-partners ".

In my opinion, this analysis is now accepted as being correct: and it remains essential to the application of the whole system, even though the connection between any particular fund of profits and a dividend paid has now become in effect untraceable, and the rule that the company recoups itself at the standard rate of tax that is current at the date of payment means that company and shareholder do not necessarily equate their respective positions as completely as the theory of the matter would require.

If, then, the dividends here in question have borne tax in the hands of the paying company and if they were therefore " franked income " in the hands of the Respondent as receiving shareholder, does the Income Tax code authorise the Revenue to enter them as a receipt in its trading account for the purpose of assessing it to tax on a separate taxable subject, that is the trading profit? To my mind, to allow it to do so would be to recognise double taxation in its most obvious form: not the less so, as I see it, because

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on the one side dividends are taxed as an aliquot share of a fund of profit and on the other they would be brought in as " mere " contributors to establish the balance of the trading profit of the individual recipient. But double taxation in itself is not something which it is beyond the power of the Legislature to provide for when constructing its tax scheme. It is rather that, given that a situation would really involve double taxation (see *Canadian Eagle Oil Co., Ltd.* v. *The King,* 27 T.C. 205) it is so unlikely that there would have been an intention to penalise particular forms of income in this way that the law approaches the interpretation of the complicated structure of the code with a strong bias against achieving such a result. This, after all, is the general principle upon which rests the particular and well-accepted rule that a form of income which is made the subject of taxation under one of the five Schedules cannot be included, directly or indirectly, as a taxable subject under another Schedule, whatever general words or general theories might seem to require. I shall allude to this principle later, since it affords, I believe, the answer to the argument of the Respondent.

Before coming to this, however, it is relevant to ask whether there has ever been a practice of making a stock dealer's tax assessments to Case I of Schedule D on the basis of bringing into account dividends and interest received. *Cenlon Finance Co., Ltd.* v. *Ellwood,* 40 T.C. 176, contains statements in this House which were evidently made in the belief that such a practice did prevail, but we are all satisfied, I think, that they were due to a misconception. The matter has been looked into carefully since the *Cenlon* decision was made public, and Counsel for the Crown has assured us that their researches contradict the existence of any such practice. Counsel for the Respondent, speaking from an exceptional range of experience, confirmed the novelty of the assumption made in *Cenlon.* I think that we must take it that it has been long-established and regular practice to exclude taxed interest and dividends from the computation. The practice with regard to finance companies was so stated in an affidavit which is reported as having been placed before the Court in *R.* v. *Commissioners of Income Tax for the City of London* (1904), 91 L.T. 94, which contained a paragraph:

> "The Income Tax authorities always insist upon dealing separately with such investments upon which the income tax is deducted at the source, and excluding the same from the profits of the trade for the purposes of assessment thereof under sched. D, and I believe they have the right to do so . . .".

The Court's decision does not deal with the propriety or otherwise of such a method of estimating assessable profits, but there does not seem to have been any dispute about it. Nor, it would appear, have there been doubts or disputes since, prior to the observations made in the *Cenlon* case.

Indeed, the practice of excluding dividends from assessments of trading profits (or losses) has been not only recognised in more than one Income Tax or Finance Act but has actually been incorporated in the structure of loss reliefs set up for the administration of the tax. I ought to add at this point that, as far as I can see, the principle for which the Respondent contends cannot be confined to the ascertainment of the profits of a finance or stock dealing concern and should just as well govern the assessment of the profits of many other kinds of trading concerns, such as banks and insurance and assurance companies and commercial and industrial firms who employ part of the capital of their business in invested reserves. However that may be, Rule 15(2) of the Rules applicable to Cases I and II of Schedule D in the

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Income Tax Act, 1918, assumed that, failing specific statutory direction, the correct form of assessment required the exclusion of dividends, and such a rule can be directly traced in the words of Section 22(2) of the Finance (No. 2) Act, 1945, of Section 18(3) of the Finance Act, 1954, and of Section 4 of the Finance (No. 2) Act, 1955. The wording employed, which speaks of dividends which would fall to be taken into account as trading receipts but for the fact that they have been subjected to tax under other provisions of the Income Tax Act, seems to me to recognise clearly enough the general accountancy claim and the special reason why, for tax purposes, dividends are excluded from trading assessments. All this, practice and legislation, may indeed have proceeded on a misconception of the law, but it would be a curious and long-standing delusion.

In my opinion, there was no misconception and no delusion. Dividends that had borne tax or suffered deduction of tax—I see no difference in this context between the two ways of putting it—before receipt are, to use Viscount Dunedin's phrase[1], " exhausted as a source of income ", and the general principle applied to the construction of the provisions of the Income Tax code prevents their being brought in again, directly or indirectly, as a subject of taxation in the form of another class of taxable income. It is neither here nor there that in the words of Section 127 of the 1952 Act tax is to be charged under Cases I and II of Schedule D on " the full amount of the profits or gains ". That has no effect on the principle of computation. The rule of excluding income which has been assessed to tax " under its own title " from insertion as an item in an assessment under Case I of Schedule D was recognised and given effect to by this House in the well known *Salisbury House* decision, 15 T.C. 266 (rents from land), and again by the Court of Appeal in *Thompson* v. *The Trust and Loan Co. of Canada*, 16 T.C. 394 (interest on Government bonds). The principle is clearly stated in the first case in the speeches of Viscount Dunedin at page 308 and of Lord Atkin at pages 319–21, and in the second case in the judgment of Lord Hanworth, M.R., at pages 406–7[2]. I regard the decision in *Hughes* v. *Bank of New Zealand*[3], [1938] A.C.366, as an enforcement of the same principle.

In the last case the exclusion was the product of the positive statutory enactment that the War Loan interest was to be free of tax. In the other two cases it was produced by the fact that the income which it was sought to include in the Schedule D assessment had borne its appropriate tax under another Schedule, Schedule A or Schedule C. Does it make any difference in the application of the principle that dividends that have suffered deduction of tax cannot be said to be taxed under a different Schedule, but are either taxed under the same Schedule (if you think of them as the residue of a taxed fund of trading profit), or under the general provisions of the tax code (which allows the company to pass on to shareholders by way of deduction and recoupment the tax that its own profits have borne)? I think that it makes no difference at all. It only throws up in the more marked form the grossness of the double taxation, if the dividends are regarded as taxable twice over under the same Schedule, once by virtue of the shareholder's participation in the company's trading profit and once by virtue of his own trading profit being augmented by the fruits of that participation.

It is common ground, I think, that the Court of Appeal's decision in this case can only be supported if certain expressions of opinion which appeared in the judgments of that Court and the speeches in this House in

(1) *See* Salisbury House Estate, Ltd. *v*. Fry, 15 T.C. 266, at p. 308.
(2) 16 T.C. (3) 21 T.C. 472.

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the *Cenlon* case[1] were correct in law. To put it briefly, Donovan, L.J., in the Court of Appeal and Viscount Simonds and Lord Denning in the House of Lords stated that in their view it would be correct to bring dividends taxed at source into the Case I Schedule D computation of the profits of a trader in stocks and shares.

My Lords, I have given my reasons for thinking that that would not be a correct taxation procedure, and I could not think otherwise, even if the *Cenlon* decision amounted to a decision of this House to that effect. Fortunately, the decision itself involved no such proposition. The views expressed were not in any sense essential to the decision nor did they represent a majority view of the House. What were being dealt with in *Cenlon* were so-called " capital dividends ", dividends distributed by a company out of a fund of " profit " that had not been taxed in its hands or taxed by way of deduction against the shareholders ; and, whatever else can be said about the taxability or non-taxability of these capital dividends in the hands of shareholders (as to which I hope that the question can still be regarded as open), it is at any rate clear that the basic reason for excluding taxed dividends from Case I computations, that they have borne tax already, is exactly what is lacking in these capital dividends, which no one taxes at present at any point. Nothing that I have said, therefore, involves any critical comment on the *Cenlon* decision as confined to such dividends.

It was, of course, appreciated when it was said that dividends taxed at source ought to enter into the computation of a dealer's trading profits, that this would involve taxing the same income twice over, a procedure that is normally regarded as unfair and unacceptable. To avoid the practical consequence of this, however, it was suggested in the *Cenlon* case that there was some equitable principle that could be invoked against the Revenue which would compel an adjustment of the tax bills on the two forms of taxed income. How far such an equity is to take the taxpayer is not stated, so I am afraid that I cannot tell whether it is an equity not to suffer more tax than that payable under the larger of the two bills or to have the tax on the dividends returned *pro tanto,* even though there is no trading loss.

With respect to those who have invoked this principle, however, I am quite unable to see where it comes from. It seems to me merely an illegitimate way of trying to mitigate the consequences of a wrong principle. It is one thing to say that the Income Tax Acts, properly interpreted, do not allow the introduction of taxed dividends into assessable trading accounts. Then the tax system works as it is intended to. To take the figures of the present case, there is a loss on trading of £895,487, which Section 341 allows to be set off against the taxed dividend income of £1,686,198. That gives a return of £404,020 by way of tax reclaimed. But if, on the other hand, the Income Tax Acts are held to require the dividends, though they have borne tax, to be written into the trading account, then there is a profit on that account of £800,000 and no trading loss. In that situation Parliament has granted tax on the full amount of the dividend income and also on the balance of the trading profit. What is there to prevent the Revenue from collecting the full tax that is due or to allow it not to collect what it ought? There is no claim for loss relief, because there is no loss ; and, so far as I am aware, there is no power in a court of law to restrain the Revenue from exacting more than so much of a tax, *ex hypothesi* granted, as the Court may think that in equity a taxpayer ought to pay. *A fortiori,* without

(1) 40 T.C. 176.

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statutory authority, there is no power in the Court to compel the Revenue to give up part of a tax that has been lawfully collected. With great respect, I do not think that there is any such equity. In my opinion, the fact that it has to be presumed in order to make a suggested interpretation of the Acts even a tolerable one shows that the interpretation itself is mistaken.

For these reasons I am of opinion that the Respondent's income during the relevant period was investment income and that it received a lawful Surtax direction on this footing. I would allow the appeal.

Lord Hodson.—My Lords, I agree.

Lord Guest.—My Lords, I have had the advantage of reading the opinion of my noble and learned friend, Lord Reid, with which I concur.

Lord Upjohn.—My Lords, I agree.

Questions put:

That the Order appealed from be reversed.

The Contents have it.

That the determination of the Special Commissioners be restored, and the question of law in the Case Stated be answered in the affirmative.

The Contents have it.

That the Respondent do pay to the Appellants their costs here and below.

The Contents have it.

That the case be remitted to the Chancery Division with a direction to make such Order as may be necessary as to the repayment of the costs already paid by the Appellants to the Respondent under the Order of Ungoed-Thomas, J., of 7th December, 1963, as will enable such costs to be reclaimed by the Appellants.

The Contents have it.

[Solicitors:—Slaughter & May; Solicitor of Inland Revenue.]