HIGH COURT OF JUSTICE (CHANCERY DIVISION)—2ND AND 3RD JULY, 1959

COURT OF APPEAL—15TH, 16TH, 17TH AND 18TH MARCH, 1960

HOUSE OF LORDS—27TH AND 28TH FEBRUARY, AND 28TH MARCH, 1961

Duple Motor Bodies, Ltd.

v.

Ostime (H.M. Inspector of Taxes) (1)

Ostime (H.M. Inspector of Taxes)

v.

Duple Motor Bodies, Ltd.

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v.

Commissioners of Inland Revenue

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v.

Duple Motor Bodies, Ltd.

Income Tax, Schedule D, and Profits Tax—Profits of trade—Valuation of work in progress—On-cost and direct cost methods.

The Appellant Company carried on the trade of building motor bodies and had since 1924 *used the direct cost method of ascertaining the cost of work in progress, under which the cost of direct materials and labour were alone taken into account. Assessments to Income Tax were made upon the Company under Case* I *of Schedule D for the years* 1951–52, 1952–53 *and* 1953–54, *and to Profits Tax for the corresponding chargeable accounting periods, on the footing that the cost of work in progress should be arrived at by the on-cost method, under which a proportion of indirect expenditure, i.e., factory and office expenses, etc., was added to the direct cost.*

On appeal, the Special Commissioners found that the accountancy profession was satisfied that either method would produce a true figure of profit for Income Tax purposes, and that which method should be used was a matter of policy for the decision of the directors of a company. The Commissioners decided, however, that in order to arrive at a true figure of the cost of work in progress a proportion of factory overheads, but not of other indirect expenditure, should be taken into account.

Held, *that the facts and findings in the Case did not justify requiring the Company to change from its practice of using the direct cost method.*

(1) Reported (Ch. D.) 103 S.J. 583; (C.A.) [1960] 1 W.L.R. 510; 104 S.J. 386; [1960] 2 All E.R. 110; 229 L.T.Jo. 254; (Appeal Committee) [1960] 1 W.L.R. 621; (H.L.) [1961] 1 W.L.R. 739; 105 S.J. 364; [1961] 2 All E.R. 167; 231 L.T. Jo. 223.

CASES

(1) *Duple Motor Bodies, Ltd.* v. *Ostime (H.M. Inspector of Taxes)*
Ostime (H.M. Inspector of Taxes) v. *Duple Motor Bodies, Ltd.*

CASE

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

1. At meetings of the Commissioners for the Special Purposes of the Income Tax Acts held on 18th, 19th and 20th July, 1956, and 29th July, 1957, Duple Motor Bodies, Ltd. (hereinafter called "the Appellant Company"), appealed against assessments to Income Tax under Case I of Schedule D for the years 1951–52, 1952–53 and 1953–54 in the sums of £250,000, £200,000 and £1,000, respectively.

2. The questions for our determination were:

(1) whether, in arriving at the cost of work in progress for the purpose of computing the profits of the Company for Income Tax purposes, the cost of direct materials and labour only ("direct cost") should be taken into account, or whether there should be added to the direct cost a proportion of indirect expenditure ("on cost"); and

(2) if on-cost was to be taken into account, what items of indirect expenditure fell to be included therein.

It was common ground that there was no question of market value of work in progress, as it could not be regarded as saleable in its unfinished state.

3. (1) On behalf of the Appellant Company the following gave evidence before us:

(*a*) Mr. H. W. Sydenham, a Fellow of the Institute of Chartered Accountants, and senior partner in the firm of chartered accountants, Messrs. Sydenham, Snowden, Nicholson & Co. Mr. Sydenham has been in practice as a chartered accountant for 30 years. He is the chairman of the Appellant Company.

(*b*) Mr. L. H. Clark, a chartered accountant and a partner in the firm of chartered accountants Messrs. Harmood Banner, Lewis & Mounsey. The head office of Mr. Clark's firm is in Liverpool, and there is a branch in London. The firm has a wide practice among merchanting and manufacturing businesses.

(2) On behalf of the Respondent (H.M. Inspector of Taxes) the following gave evidence before us:

(*a*) Mr. R. B. Lloyd. He had retired in 1956 as a Senior Inspector of Taxes, although at the date of this appeal he was still employed by the Inland Revenue as an Inspector of Taxes. He had had, during his employment in the Inland Revenue, considerably experience in dealing with the taxation affairs of manufacturing businesses, particularly light engineering, including motor-body building.

(*b*) Mr. F. W. Gower, chartered accountant and senior advisory accountant to the Board of Inland Revenue.

4. The Appellant Company was incorporated in July, 1946, and took over the business of a company which had been incorporated in 1919. Its business is that of building to order bodies for different types of road vehicles, now mostly motor coaches, and its turnover in the period 1948 to 1954 has been in excess of £1,000,000 per annum. Almost entirely the bodies are built

to the specifications of the individual purchasers, and the Appellant Company's business is not that of mass production. It never buys a chassis. The business is now seasonal, the busy season ending about the end of June. Since the business is almost entirely that of building bodies to order, very few finished bodies are included in work in progress at the end of an accounting period. Since 1924 the Appellant Company and its predecessor have used the direct cost method in ascertaining the cost of work in progress in their annual accounts.

5. We were asked, in the first instance, to decide as a broad matter of principle whether the direct cost method or the on-cost method was to be applied in ascertaining the cost of work in progress for the purposes of computing the Case I profits; and on this basis we were asked to consider the accounts for the year to March, 1951, as an example.

6. There is annexed hereto, marked "I" and forming part of this Case (1), a document which contains:

(1) Summary of balance sheets for the seven years to 31st March, 1953, and of the balance sheet at 30th June, 1954. For the year to 31st March, 1951, there is an item "Work-in-Progress & Finished Stock, £136,109". This figure represents only the cost of labour and materials. From the nature of the Appellant Company's business, i.e., almost entirely building bodies to order, and from the method of keeping its records, it is possible to identify the cost of materials used and labour employed in the making of each body. The figure of £136,109 is the actual cost of the materials used in each separate job and the actual cost of the labour of individual men working on each job. As indicated in paragraph 4 above, the figure in respect of finished stock (bodies) included in the figure of £136,109 is very small.

(2) Summary of manufacturing and trading accounts for the above-mentioned periods. For the year to 31st March, 1951, there appears the same figure of £136,109 for "Work-in-Progress & Finished Stock (Closing)".

(3) Summary of profit and loss accounts (credits) for the above-mentioned periods.

(4) Summary of profit and loss accounts (debits) for the above-mentioned periods. For the year to 31st March, 1951, there appear two items: (*a*) "Unproductive Labour & Works Costs on Miscellaneous Shop Work & Supplies—as per separate Schedule annexed, £93,750". This figure is analysed in (5) below. (*b*) "Sundry Charges—ditto, £91,078". This figure is analysed in (6) below.

(5) Analysis of item "Unproductive Labour . . .".

(6) This schedule has no heading (except the name of the Appellant Company), but it contains an analysis of the figure of £91,078 referred to in (4) (*b*) above.

There is also annexed hereto, marked "II" and forming part of this Case(1), a document headed "Miscellaneous Shop Work and Supplies". For the year to 31st March, 1951, it contains an analysis of the figure of £40,707, which appears in No. (5), above, of exhibit I, under the description "General".

These two exhibits were the documents before us when we gave our decision in principle on the question set out in paragraph 5 above. We do not think it necessary to say more at this stage about the various schedules referred to in exhibits I and II above, except that on the on-cost method some part of the items set out in the documents I (4), (5) and (6) and II would have to be added to the direct cost figure of £136,109.

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(1) Not included in the present print.

7. As regards these two methods of ascertaining the cost of work in progress (the direct cost method and the on-cost method), we find that the position is as follows:

(*a*) Both methods are recognised by the accountancy profession as correct accountancy. There is no cleavage of opinion in the profession as a whole in the sense that the advocates of one method consider the other method wrong or unsound. We think it right to say, however, that Mr. Sydenham himself considered the on-cost method definitely unsound, but he thought, and we so find, that he is in a minority in holding this opinion. Professional accountancy opinion is rarely static on questions of this kind: we find that, up to fairly recently, the weight of accountancy opinion was in favour of the on-cost method, but that now the trend in the profession is slightly away from this method.

(*b*) On the evidence adduced before us we find, and this naturally has caused us difficulty, that the accountancy profession as a whole is satisfied that either method will produce a true figure of profit for Income Tax purposes. In this state of affairs we find that it is very much a matter of policy for the decision of the directors of a company which method should be used.

(c) In dealing with the Inland Revenue the majority of taxpayers either submit accounts in which the on-cost method has been applied in the accounts, or, if this method has not been applied in the accounts, computations of the Case I profits in which the on-cost method is applied are submitted together with the accounts.

(*d*) There are several different ways of applying the on-cost method. Indirect expenditure is quite commonly divided by cost accountants into headings of: (*a*) factory expenses; (*b*) office expenses; (*c*) selling expenses; (*d*) dispatch and financial expenses. It is a common, but not universal, method of applying the on-cost method to include in the cost of work in progress a proportion of either all the factory expenses or of some only of them, and to exclude the other headings of indirect expenditure.

(*e*) If the on-cost method is applied, different accountants may apply different recognised variations of this method; and, whatever recognised variation of this method is applied, the accountancy profession as a whole would not condemn any particular recognised variation as being unsound. Furthermore, we find that there is considerable scope for difference of opinion as to how a recognised variation of the on-cost method should be applied to the facts of each particular case.

(*f*) In the application of the direct cost method there is room for difference of opinion in the accountancy profession, and also for an element of estimation. Mr. Sydenham had earlier considered certain items of expenditure to be items of indirect expenditure; but before us he stated that he had come to the conclusion that some of these items were items of direct expenditure, and that as to others he had a doubt, but they could not unreasonably be considered direct expenditure. Some items which Mr. Sydenham considered were items of direct expenditure were, in this particular case, for practical reasons, estimated. For example, it would be possible, by various metering devices, to ascertain precisely what proportion of the cost of power and of gas was appropriate to a particular body: it was not reaonably practical to do this and an estimate would be made, but this estimate would be regarded as direct expenditure.

(*g*) One result of the on-cost method is that the cost of work in progress varies with the rate of production. If a factory is not working at full capacity, the cost of work in progress computed by this method is higher than if the

factory is working at full capacity. On the direct cost method the cost of work in progress is not affected by the rate of production.

(*h*) There was produced in evidence before us a booklet, "Recommendations on Accounting Principles", issued by the Institute of Chartered Accountants in England and Wales. The only paragraphs which seemed to us to be material are paragraphs 107 to 112 (which, although dealing with stock-in-trade generally, also apply to work in progress), which are as follows:

"107 No particular basis of valuation is suitable for all types of business but, whatever the basis adopted, it should be applied consistently, and the following considerations should be borne in mind:

108 (A) Stock-in-Trade is a current asset held for realisation. In the balance sheet it is, therefore, usually shown at the lower of cost or market value.

109 (B) Profit or loss on trading is the difference between the amount for which goods are sold and their cost, including the cost of selling and delivery. The ultimate profit or loss on unsold goods is dependent upon prices ruling at the date of their disposal, but it is essential that provision should be made to cover anticipated losses.

110 (C) Inconsistency in method may have a very material effect on the valuation of a business based on earning capacity though not necessarily of importance in itself at any balance sheet date.

The following interpretations are placed on the terms 'cost' and 'market value':

111 (*a*) 'Cost'

The elements making up cost are (i) the purchase price of goods, stores and, in the case of processed stock, materials used in manufacture; (ii) direct expenditure incurred in bringing stock-in-trade to its existing condition and location; and (iii) indirect or overhead expenditure incidental to the class of stock-in-trade concerned.

112 Whereas the cost of (i) and (ii) can be ascertained with substantial accuracy, (iii)—indirect or overhead expenditure—can only be a matter of calculation. If (iii) is expressed as a percentage of actual production, the amount added to the stock valuation will fluctuate from one period to another according to the volume produced. To avoid distortion of revenue results, in some cases indirect or overhead expenditure is eliminated as an element of cost when valuing stock-in-trade or, alternatively, only that part which represents fixed annual charges is excluded. In other cases, an amount is included which is based on the normal production of the unit concerned."

This booklet is not annexed hereto, but is available for the use of the High Court if required.

8. The following cases were referred to in the course of the hearing before us:

Ryan v. *Asia Mill, Ltd.*, 32 T.C. 275.
Patrick v. *Broadstone Mills, Ltd.*, 35 T.C. 44.
Minister of National Revenue v. *Anaconda American Brass, Ltd.*, [1956] 1 All E.R. 20.
Owen v. *Southern Railway of Peru, Ltd.*, 36 T.C. 602.
Whimster & Co. v. *Commissioners of Inland Revenue*, 12 T.C. 813.
Johnson v. *W. S. Try, Ltd.*, [1946] 1 All E.R. 532; 27 T.C. 167.

9. It was contended on behalf of the Appellant Company:

(1) that, in computing profits for Income Tax purposes, the amount to be taken into account in respect of work in progress is the amount of expenditure actually incurred directly and proximately in producing it, that is to say, the cost of materials used, labour expended and other direct expenses;

(2) that all other expenses are properly deductible in arriving at the profits of the year in which they are incurred;

(3) that the level of overhead expenses of a business depends upon the

general extent and organisation of that business, does not vary directly with the volume of production, and so is not directly connected with that production;

(4) that, on the evidence, it could not be said either that the direct cost method of valuation was inconsistent with the principles of commercial accounting, or that it did not produce a true figure of profit for Income Tax purposes;

(5) that the method (direct cost) adopted by the Company in computing its profits could not be displaced by the Revenue unless (which was not the case) it was shown to be inconsistent with the principles either of commercial accounting or of Income Tax;

(6) that the direct cost method contained no element of arbitrary estimation, whereas the on-cost method did contain such an element;

(7) that, for the purposes of ascertaining the true Income Tax profits for a year of assessment, a method which contained no element of arbitrary estimation was preferable to a method which did contain such an element;

(8) that for these reasons the direct cost method should be applied in this case.

10. It was contended on behalf of the Respondent (H.M. Inspector of Taxes):

(1) that, where there is more than one method for arriving at the profits for a relevant period, that one which shows most accurately the position between the Revenue on the one hand and the taxpayer on the other so as to give the true profit of a particular accounting period ought to be adopted;

(2) that accordingly, in arriving at the Company's true profits for Income Tax purposes, the value of work in progress and finished goods at the end of an accounting period must be credited in the accounts at full cost, that is to say, the direct cost with the addition of the proportion of overhead expenses referable to such work in progress and finished goods;

(3) that to exclude all overhead expenditure from the cost of work in progress is, in effect, to allocate the whole of such expenditure to the sales which had been effected during the accounting period;

(4) that at least some part of indirect expenditure has been expended on work in progress, and that it cannot be correct, in arriving at the Case I profits of an accounting period, to allocate (as the direct cost method does) the whole of this indirect expenditure to sales which have been effected during that accounting period;

(5) that the on-cost method produces the true view of the Case I profit for a year of assessment and that the direct cost method does not, and that therefore the on-cost method should be applied in this case.

11. We, the Commissioners, who heard the appeal, gave our decision in principle as follows:

We have been asked to decide this appeal on a broad question of principle, and we are going to do that, fully aware that in doing so we shall be leaving open a wide field for discussion between the parties; but we feel that, having to decide this as a broad question of principle, that is really inevitable and cannot be helped.

We think that, on the broad general question, the appeal fails. The position here is that we have a Company manufacturing vehicle bodies, and at the end of every year this Company has on hand a number of finished but unsold bodies, and also a number of unfinished bodies; and it is agreed between the parties that these finished and unsold bodies and unfinished bodies—that is to say, work in progress and stock—have to come into the profit and loss account at the end of the year. It is further agreed that those things must come in at cost; it is agreed that there is no question before us of market value.

The problem is one very easy indeed to state, however difficult it is to answer. We have found the problem very difficult. The simple question is: How do you get at the cost of this work in progress? In the accountancy world there are two views. The view of the Appellants (which we will call the direct cost view) is that the cost is to be ascertained by taking only the cost of labour and material involved in any particular body, and that cost only. The method adopted by the Crown is the on-cost method. They say that to ascertain the cost of work in progress you have to add some proportion of overheads. The Appellants say that indirect costs, such as overheads, are incurred whether production is continuing or not, and that to apply the on-cost method will in certain circumstances produce a distortion of the figure of profits. The Appellants also say: "We work on known or perfectly accurate ascertainable figures, and on this kind of basis you arrive at a truer view of cost than you do on the on-cost method."

The Crown contend that some part of these overheads must go into the cost of work in progress. When the factory is not running at full capacity, the Crown say, it is obvious that production costs more—that is, it costs more, if the factory is not running at full capacity, to make a particular vehicle. That is a fact, the Crown contend, and that kind of fact ought to be reflected in the accounts; and the on-cost method does reflect that kind of fact.

We have had evidence on both sides, and we will state our view of the evidence quite shortly, without going into detail. Mr. Sydenham thought that on-cost was an unsound method of arriving at cost; but he said that he thought he was in a minority amongst his accountancy brethren in holding that opinion. We think that he is in a minority, and that is borne out by the evidence of Mr. Clark. Mr. Clark's evidence comes really to this, that the two methods are both accepted in the accountancy profession, and that you cannot say there is a general opinion in the accountancy profession that the on-cost method is unsound. Mr. Clark told us that each method will produce a true view of profits for Income Tax purposes; and we think we might say here that we consider it important that ascertaining profits for Income Tax purposes does involve ascertaining profits year by year.

We think we should say here something about what we understand to be the position on authority. We think that the present position on the authorities is that, if a matter is not specifically provided for by the Income Tax Acts, we ought to accept general accountancy practice, but with this important proviso: we must still be satisfied that this general accountancy practice does produce true profits for Income Tax purposes. The mere fact that there is a general accountancy practice is not, at the present stage of authority, we think, enough. It appears clear to us that, if you are trying to get at the true Income Tax profits, inevitably in some cases (if not in many) an element of estimation comes into ascertaining those profits. We think the authorities show that, if estimation is necessary, we must choose as between two methods the one that gets nearest to the reality of the case. That is our view on the authorities as they stand at present.

In that position, on the evidence and guided by the authorities, we can state our opinion very shortly. We feel in the end that to get at the true cost of producing an article—that is, the cost of making the thing—there is really something more in the cost than the mere cost of labour and the cost of the material that has gone into that particular article. It seems to us that it has really cost more to build a vehicle body than just the cost of labour and material. The object of the on-cost method—whether we are right or wrong about this—is really to get at the cost; and, as we are coming down on the side of the on-cost method, it appears to us that any proportion of overheads, which on that method is to be attributed to cost, should be limited to factory overheads, namely, the overheads of the place where the thing is actually being made. We realise that the expression "factory overheads" is rather vague; but, since we are asked to decide this matter on a broad question of principle, we feel, as we have already said, that it is inevitable that a wide field for discussion should be left open, and we do not feel able to define the term "factory overheads". We think that the proportion of overheads to be attributed to the cost of building a vehicle body should be limited to a proportion of factory overheads.

We are confirmed in our view that "on-cost" is really, in this kind of case, the better method to follow by the recommendations of the Institute of Chartered Accountants. We refer to paragraph 111 of the book which has been put in called "Recommendations on Accounting Principles". Sub-paragraph (*a*) of that paragraph is headed "Cost", and it reads:

> "The elements making up cost are (i) the purchase price of goods, stores and, in the case of processed stock, materials used in manufacture; (ii) direct expenditure incurred in bringing stock-in-trade to its existing condition and location; and (iii) indirect or overhead expenditure incidental to the class of stock-in-trade concerned."

If you stop there, it seems to us that the Institute is saying that some element of overheads does come into "on-cost". We do not propose to read paragraph 112, but merely to say that, on our view, that paragraph is only saying that if you have to introduce an element of estimate in using this "on-cost" method, you must be a little careful in how you use it. We do not read this paragraph 112 as saying anything more than that.

Before concluding, we think we should say something about the passage to which we have been referred from Lord Reid's speech in *Ryan* v. *Asia Mill, Ltd.*, 32 T.C. 275, at page 298, because Mr. Cyril King did rely a good deal on that passage. It reads:

> "The Solicitor-General's argument was that these were payments which, though not part of the price, 'had the effect of adding to or reducing the total outlay attributable to their stock as a whole': I quote from a passage [1] in the judgment of Jenkins, L.J., which the Solicitor-General maintained correctly set out the principle to be applied. I cannot agree that every payment or receipt which has that effect must come in to the cost of the stock. If a trader keeps perishable stock for a considerable time he may have to incur large expense in keeping it in proper condition—expense which he would not have incurred if he had not been carrying the stock. In such a case it could be said that when the trader comes to use the stock it has cost him not only its price but also all that he has spent on keeping it but would not have had to spend if he had not had it in his possession."

On that passage we think, first of all, that Mr. Gower was right when he said in cross-examination that Lord Reid is there dealing merely with the rather special facts of that case. Secondly, we do not know the "on-coster's" view—if we may call it that—about this; but it seems to us at least sensible and reasonable to say that the cost of storing or keeping a thing, once you have made it, is not really part of the cost of making that thing, and Lord

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[1] 32 T.C., at p. 291.

Reid is saying that that cost is part of the cost of the stock. In our view, that is all his Lordship appears to us to be saying there. Thirdly, he says that not all of these expenses which he mentions can be taken into account. That does not seem to us to be the same thing as saying that none of them are ever to be taken into account. So we do not find that we get a great deal of help from that passage in Lord Reid's speech.

We finish where we began, by saying we know full well that we have left a wide area open. We do not think we can help that. If, of course, the parties are unable to come to any settlement on the basis of what we have said today, they will come back to us.

The appeal fails and we leave the figures to be agreed.

12. The parties were unable to agree the figures on the basis of the above decision in principle, and there was a further hearing on 29th July, 1957, when Mr. Sydenham again gave evidence.

The arguments and contentions at this hearing were not directed to the question whether our earlier decision in principle was correct or not, but solely to the question what were "factory overheads" within the meaning of that earlier decision.

13. There is annexed hereto, marked "III" and forming part of this Case (1), a document containing schedules headed "A" to "F". All of these schedules except "F" cover the four years ended 31st March, 1953, together with the fifteen-month period to 30th June, 1954. This time we were asked to take as an example the year to 30th March, 1950, and we confine our remarks on the various schedules to that year.

14. Schedule "A" of exhibit III has on the left-hand side four sub-divisions. These sub-divisions are as follows:

"1. Direct Expenses" (total, £48,329). There is now no dispute about this. It is agreed that, quite apart from our earlier decision in principle, none of the items under this sub-division is overhead expenses, and that all of them should be brought in as direct expenditure in ascertaining the cost of work in progress.

"2. 'Factory Overheads' " (total, £148,956). Details of the composition of this figure of £148,956 are set out in schedule "B" of exhibit III. In agreeing to the description of No. 2 of schedule "A" as "factory overheads" and in agreeing the details of schedule "B", the Appellant Company was not admitting that all the items in schedule "B" which go to make up the total of £148,956 were "factory overheads" within the meaning of our earlier decision in principle. Schedule "B" was agreed to by the Appellant Company on the basis of including everything which on any possible view could be described as "factory overheads", and the right was reserved, as will appear later, to contend that some of the items in schedule "B" were not "factory overheads" within the meaning of our earlier decision in principle. In view of the decision in principle we came to on this hearing, we think it is necessary to describe only the following items in this schedule "B":

(1) "Idle Time, £20". "Idle time" was the time of skilled men normally employed in the actual building of bodies which for one reason or another (e.g., no work of this nature being immediately available) was not spent on the work of building bodies. If the labour of these men could be employed for some other job, it was so used; but occasionally there was nothing for them to do at all, but they were paid nevertheless.

(1) Not included in the present print.

(2) "Repairs and Maintenance (part) (*a*) regarded as Deferred Repairs for E.P.T., £1,071". This represented factory expenditure which in the ordinary course of events would have been undertaken during the period of Excess Profits Tax. "Repairs and Maintenance (part) (*b*) other repairs, £1,422". This description is really self-explanatory; it was expenditure on making good past use of premises, plant, etc.

(3) "Repairs and Maintenance of Plant, Machinery and Tools and Furniture and Fittings (part), £21,997". This description, also, is self-explanatory, and the expenditure was of the same nature as that in (2) above, except that there would be included a small expenditure of a day-to-day nature, such as the cost of oiling the plant or keeping it running.

(4) "Guarantee and Replacement Costs, £3,495". This was expenditure on making good things which have been made in the past and have proved to be faulty.

(5) "Staff Pensions schemes (part) . . . Past Service (estimated—half), £954". This represented additional payments to enable the insurance company to provide pensions in respect of service performed before the Appellant Company had inaugurated a pension scheme.

(6) "Depreciation" (£3,150 and £6,000). Mr. Sydenham agreed that these would be "factory overheads" within the meaning of our earlier decision in principle, but they were items which, as such, were not allowable as deductions in computing Case I profits.

"3. Office, Selling and Financial Expenses" (total, £83,681). Details of some, but not all, of the items which go to make up this total of £83,681 are set out in schedule "C".

"4. Other Expenses" (total, £27,770), made up of various miscellaneous items.

15. Schedule "C" is compiled on the following basis:

In the discussions between the parties following on our earlier decision in principle, it was suggested on behalf of the Crown that there might be some items in the total of £83,681—i.e., No. 3 of schedule A, "office, selling and financial expenses"—which the Crown might wish to contend were "factory overheads" within the meaning of our earlier decision in principle. The Appellant Company's representatives accordingly extracted some of the items, or a proportion of some of the items, going to make up the total of £83,681, and set them out in schedule "C". It will be seen that the balance of some of the items in this schedule "C" has already been included in No. 2 of schedule "A" ("factory overheads").

16. Schedule "D" is compiled on the following basis:

From schedule "C" the Crown's advisers extracted certain items, or a proportion of certain items, which, the Crown contended, were "factory overheads" within the meaning of our earlier decision in principle. These items appear in (*a*) of this schedule "D". In (*b*) of this schedule "D" there are two items ("Experimental Work and Patterns & Jigs, £8,196"; "Salaries—Experimental, £782") and a proportion of a third item ("Canteen Loss (or Profit), £272" (a loss)) which all appear in No. 4 of schedule "A". Again it was contended on behalf of the Crown that these sums were "factory overheads" within the meaning of our earlier decision in principle.

17. Schedule "E" has a self-explanatory heading. The method of arriving at the various percentages as percentages of productive wages is agreed by both parties.

18. Schedule "F" contains computations of the Case I profits based on the interpretation by the respective parties of our decision in principle.

For the year ended 31st March, 1951, the figure of £113,334—the total down to the description "Adjustment (acceptable to the Company) for proportion of Direct Expenses attributable to Work in Progress and Finished Stock: (as per schedule "E" item 3)—was accepted by the Appellant Company. The figure of £14,945, "Adjustment for proportion of total 'Factory Overheads' (on basis of Special Commissioners decision of 20th July 1956 as understood by the Company)", etc., derives, through No. 4 of schedule "E", from schedule "B". As has already been explained (paragraph 14, schedule "A" "2", above), the Appellant Company contended that some of the items in schedule "B" were not "factory overheads" within the meaning of our earlier decision in principle. The figure of £1,278, "Adjustment for the further items claimed by the Revenue" derives, through Nos. 5 and 6 of schedule "E", from schedule "D", both (*a*) and (*b*). As will be seen, the Appellant Company contended that no part of this figure of £1,278 should be included in arriving at the cost of work in progress.

19. It has already been stated that the Appellant Company agrees that all the items included in schedule "A" under the sub-division "1. Direct Expenses" were, quite apart from our earlier decision in principle, "direct expenditure", and should be included in ascertaining the cost of work in progress (paragraph 13 above).

20. It was contended on behalf of the Appellant Company:

(*a*) that, as regards the sub-division No. 2 of schedule "A" ("factory overheads"), the details of which appear in schedule "B", the following items in particular in schedule "B" should not be included. Factory overheads as defined by us: (1) idle time; (2) repairs and maintenance (factory); (3) repairs and maintenance of plant; (4) guarantee costs; (5) staff pensions: past service; (6) depreciation;

(*b*) that, as regards the sub-divisions Nos. 3 and 4 of schedule "A", no part of these came within our definition of factory overheads and that therefore no part should be included in ascertaining the cost of work in progress.

21. It was contended on behalf of the Respondent (H.M. Inspector of Taxes):

(*a*) that the whole of the sub-division No. 2 of schedule "A" should be included in ascertaining the cost of work in progress;

(*b*) that, as regards the sub-divisions Nos. 3 and 4 of schedule "A", those items of these sub-divisions which are detailed in schedule "D" should be included in ascertaining the cost of work in progress.

22. We, the Commissioners who heard the appeal, gave our decision on these contentions as follows:

(1) We found that all the items of the sub-division No. 2 of schedule "A" which are detailed in schedule "B" were "factory overheads" within the meaning of our earlier decision in principle, except: (i) repairs and maintenance regarded as deferred repairs for Excess Profits Tax; (ii) guarantee and replacement costs; (iii) staff pensions scheme, past service.

(2) We found that no part of sub-divisions Nos. 3 and 4 of schedule "A" was "factory overheads" within the meaning of our earlier decision in principle.

(3) We held that the percentages expressed as percentages of productive

wages (which will be found in schedule "E") were the correct percentages to apply, since these had been agreed between the parties.

(4) We left the figures to be agreed.

23. On being informed that the figures had been agreed, we adjusted the figures of the assessments as follows:

1951–52 Reduced to £100,830.
1952–53 Reduced to £ 76,959.
1953–54 Reduced to Nil.

24. Both parties immediately after the determination of the appeal declared to us their dissatisfaction therewith as being erroneous in point of law and in due course each party required us to state a Case for the opinion of the High Court pursuant to the Income Tax Act, 1952, Section 64, which Case we have stated and do sign accordingly.

25. The questions of law for the opinion of the High Court are:

(1) whether, on the evidence and in view of our findings set out above, our decision that the on-cost method should be applied in arriving at the cost of work in progress for the purpose of computing the Company's Case I profits was erroneous in law;

(2) on the basis that we were correct in applying the on-cost method, whether our decision as to what items should be included in arriving at cost on this method was erroneous in law.

R. W. Quayle
W. E. Bradley
} Commissioners for the Special Purposes of the Income Tax Acts.

Turnstile House,
94–99, High Holborn,
London, W.C.1.
1st August, 1958.

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(2) *Duple Motor Bodies, Ltd.* v. *Commissioners of Inland Revenue*
Commissioners of Inland Revenue v. *Duple Motor Bodies, Ltd.*

CASE

Stated under the Finance Act, 1937, Fifth Schedule, Part II, Paragraph 4, and the Income Tax Act, 1952, Section 64, by the Commissioners for the Special Purposes of the Income Tax Acts for the opinion of the High Court of Justice.

1. At meetings of the Commissioners for the Special Purposes of the Income Tax Acts held on 18th, 19th and 20th July, 1956, and 29th July, 1957, Duple Motor Bodies, Ltd. (hereinafter called the "Appellant Company"), appealed against assessments to Profits Tax as follows:

Accounting period	*Net profits*	*Profits Tax payable*
	£	£
1st April, 1950, to 31st December, 1950.	120,000	24,000
1st January, 1951, to 31st March, 1951.	40,000	12,000
1st April, 1951, to 31st December, 1951.	70,000	23,000
1st January, 1952, to 31st March, 1952.	24,000	3,400

2. The facts, contentions and our decision in principle were the same as those in the Appellant Company's appeal against assessments to Income Tax under Case I of Schedule D for the years 1951–52 to 1953–54, in which appeal we have stated a Case for the opinion of the High Court. A copy of this Case Stated is not annexed hereto, but is available for the use of the High Court if required.

3. Having been informed that the figures had been agreed, we adjusted the assessments as follows:

Accounting period	*Profits Tax payable* £ *s.* *d.*
1st April, 1950, to 31st December, 1950.	17,907 16 0
1st January, 1951, to 31st March, 1951.	8,971 16 0
1st April, 1951, to 31st December, 1951.	21,533 12 0
1st January, 1952, to 31st March, 1952.	3,051 16 6

4. Both parties immediately after the determination of the appeal declared to us their dissatisfaction therewith as being erroneous in point of law and in due course each party required us to state a Case for the opinion of the High Court pursuant to the Finance Act. 1937, Fifth Schedule, Part II, Paragraph 4, and the Income Tax Act, 1952, Section 64, which Case we have stated and do sign accordingly.

5. The questions of law for the opinion of the High Court are the same as those in the above-mentioned Income Tax appeal.

R. W. Quayle
W. E. Bradley
} Commissioners for the Special Purposes of the Income Tax Acts.

Turnstile House,
94-99 High Holborn,
London, W.C.1.
1st August, 1958.

The cases came before Vaisey, J., in the Chancery Division on 2nd and 3rd July, 1959, when judgment was given against the Crown, with costs.

Mr. Roy Borneman, Q.C., and Mr. H. Major Allen appeared as Counsel for the Company, and Mr. Geoffrey Cross, Q.C., and Mr. Alan Orr for the Crown.

Vaisey, J.—I am very troubled about this case. It comes before me in a way which, though I do not describe it as unprecedented, is certainly unusual. The questions which arose for determination by the Special Commissioners can be very shortly stated. Reading from the Stated Case now before me, the questions were, first,

> "whether, in arriving at the cost of work in progress for the purpose of computing the profits of the Company for Income Tax purposes, the cost of direct materials and labour only"

—which is commonly called the direct cost method—

> "should be taken into account, or whether there should be added to the direct cost a proportion of indirect expenditure"

—which last-mentioned method is known as the on-cost method. Further, it was asked,

(Vaisey, J.)

> "if on-cost was to be taken into account, what items of indirect expenditure fell to be included therein"?

No question arose as to the market value of the work in progress. It could not be regarded as saleable, as is obvious; and so the Commissioners have found.

Certain evidence was called by the Appellant Company, Duple Motor Bodies, Ltd., the first witness being Mr. Sydenham, a Fellow of the Institute of Chartered Accountants and holding other qualifications. He is the senior partner in a firm of chartered accountants. He has been in practice for 30 years and is still in practice, and at all material times he was the chairman of the Appellant Company. The Commissioners had before them also another chartered accountant, Mr. Clark, a partner in the firm of Harmood Banner, Lewis & Mounsey, which firm was said to have a wide practice among merchanting and manufacturing businesses. The Inspector of Taxes gave evidence and called a Mr. Lloyd, who had retired in 1956 as a Senior Inspector of Taxes although he was still employed by the Inland Revenue as an Inspector. During his employment with the Inland Revenue, he had had considerable experience in dealing with the taxation affairs of manufacturing businesses, particularly light engineering, including motor body building.

Motor body building is the activity carried on by the Appellant Company. The Company was incorporated in 1946 and took over the business of a company which previously carried on the same business and which, in fact, had been incorporated in 1919. The business carried on by the present Appellant Company and its predecessor was the building to order of motor bodies. It did not, I think, have anything to do with the manufacturing of chassis or anything of that kind; the Company built motor bodies to fit them and accommodate them for use on motor chassis, and it is those motor bodies which are the subject-matter of this case, in that it is the cost of the motor bodies which has to be estimated for the purposes of Income Tax assessment.

The Case Stated says—and no doubt this is admitted—

> "Since the business is almost entirely that of building bodies to order, very few finished bodies are included in work in progress at the end of an accounting period. Since 1924 the Appellant Company and its predecessor have used the direct cost method in ascertaining the cost of work in progress in their annual accounts."

The direct cost method, as opposed to the on-cost method, has been adopted by the Appellant Company and its predecessor in the present case for some 35 years. Certain accounts were laid before the Commissioners, and then, in paragraph 7, the Commissioners proceed to deal with the real question at issue in this matter:

> "As regards these two methods of ascertaining the cost of work in progress (the direct cost method and the on-cost method), we find that the position is as follows: (*a*) Both methods are recognised by the accountancy profession as correct accountancy. There is no cleavage of opinion in the profession as a whole in the sense that the advocates of one method consider the other method wrong or unsound. We think it right to say, however, that Mr. Sydenham himself considered the on-cost method definitely unsound, but he thought, and we so find, that he is in a minority in holding this opinion. Professional accountancy opinion is rarely static on questions of this kind: we find that, up to fairly recently, the weight of accountancy opinion was in favour of the on-cost method, but that now the trend in the profession is slightly away from this method."

I come now to a part of the findings to which great attention must be paid:

> "On the evidence adduced before us we find, and this naturally has caused us difficulty, that the accountancy profession as a whole is satisfied that either method will produce a true figure of profit for Income Tax purposes."

(Vaisey, J.)

I make merely this comment on that sentence: exactly why the Commissioners were embarrassed by such evidence and in arriving at such a finding, I have some difficulty in appreciating. It seems to me to be a quite plain statement of fact, that professional opinion, that is the opinion of skilled accountants, is "satisfied"—a very strong expression—"that either method"—that is, direct cost or on-cost—"will produce a true figure of profit for Income Tax purposes." As I say, I do not quite know why the Commissioners should have had difficulty with it.

In the same sub-paragraph, the Commissioners go on to say:

> "In this state of affairs we find that it is very much a matter of policy for the decision of the directors of a company which method should be used."

The comment I make on that sentence is that "very much" might mean "to a very large extent", which would be one construction consistent with the language used, or it may mean "essentially"—"very much" in the sense of "essentially a matter of policy for the decision of directors which method should be used".

Reading those two sentences together, it seems to me that a plainer statement of facts, and the conclusions which have to be drawn from the facts, would be very difficult to imagine. First, they say that the accountancy profession as a whole is satisfied that both methods are quite proper and produce a true result for Income Tax purposes, and then they say—I should have thought it was the necessary *sequitur* from the first sentence—that it is a matter of policy for the decision of directors which method should be adopted. If the matter had stopped there, there would have been no ambiguity in this Stated Case, and one would have thought that the conclusions which the Commissioners had reached were perfectly plain and unqualified. It really came to this, that as between the two methods of accountancy, direct cost and on-cost, either is perfectly valid for Income Tax purposes. If that is so, if both methods are all right—if I may use that colloquial expression—who is the proper person to decide which of the two shall be adopted? I should have thought that no authority would be needed for saying that if there are two proper methods of accounting it is for the directors of a company to say which of them they prefer to adopt. In the present case Mr. Sydenham, the chairman of the Company, took a certain view, as I have already said; and, although he admits that he is in a minority in holding the opinion, he thinks that the on-cost method is not satisfactory.

Up to this point the matter is perfectly clear, but then the Case goes on, in considerable detail, to deal with the various methods of applying the on-cost method. It refers also to the method of applying the direct cost method. Substantial quotations are made from a book issued by the Institute of Chartered Accountants, to which the attention of the Commissioners had been drawn.

Beginning at paragraph 9, the contentions of the parties are set out:

> "It was contended on behalf of the Appellant Company: (1) that, in computing profits for Income Tax purposes, the amount to be taken into account in respect of work in progress is the amount of expenditure actually incurred"

—that is the direct cost method. There are then references to what the submissions were in respect of other expenses properly deductible, and I need not go into that. The Commissioners set out the contentions in regard to the level of overhead expenses of a company such as the Appellant Company, and so on, and then, in sub-paragraph (7), it is contended

> "that, for the purposes of ascertaining the true Income Tax profits for a year of assessment, a method which contained no element of arbitrary estimation was preferable to a method which did contain such an element".

(Vaisey, J.)

In other words, it is submitted on behalf of the Appellant Company that, as between the two possible methods, the straightforward method which does not involve elaborate calculations and arbitrary estimations of overhead charges (using the expression in colloquial fashion)—that is, the direct cost method—is the better and more simple method, and that is the one they prefer to use.

The Inspector of Taxes takes the other view. It was contended

> "(1) that, where there is more than one method for arriving at the profits for a relevant period, that one which shows most accurately the position between the Revenue on the one hand and the taxpayer on the other so as to give the true profit of a particular accounting period ought to be adopted; (2) that accordingly, in arriving at the Company's true profits for Income Tax purposes, the value of work in progress and finished goods at the end of an accounting period must be credited in the accounts at full cost, that is to say, the direct cost with the addition of the proportion of overhead expenses referable to such work in progress and finished goods; (3) that to exclude all overhead expenditure from the cost of work in progress is, in effect, to allocate the whole of such expenditure to the sales which had been effected during the accounting period; (4) that at least some part of indirect expenditure has been expended on work in progress, and that it cannot be correct, in arriving at the Case I profits of an accounting period, to allocate (as the direct cost method does) the whole of this indirect expenditure to sales which have been effected during that accounting period".

Finally, it was submitted on behalf of the Inspector of Taxes

> "that the on-cost method produces the true view of the Case I profit for a year of assessment and that the direct cost method does not, and that therefore the on-cost method should be applied in this case."

That is the view of the Inspector of Taxes. It seems quite inconsistent with the findings of the Commissioners which I have already read, in the two sentences upon which I have dwelt at great length. I do not suppose there is anyone who doubts that the Inspector of Taxes prefers the on-cost method, which he thinks produces a more just estimate; and if he or the Commissioners had been directors of the Company they could have adopted the on-cost method if they had liked. That is, indeed, the finding of the Commissioners: that "it is very much a matter of policy for the decision of the directors". If so minded, they could, if they were directors of the Company, adopt the on-cost method and reject the direct cost method.

I come now to paragraph 11 of the Case, in which the Commissioners give what they call "our decision in principle". They begin by saying that they have been asked to decide the appeal

> "on a broad question of principle",

and they say that they propose to do that, being

> "fully aware that in doing so we shall be leaving open a wide field for discussion between the parties; but we feel that, having to decide this as a broad question of principle, that is really inevitable and cannot be helped."

What does that mean? It comes to this, I think, that the Commissioners themselves think that if they had been sitting on the board of directors of this Company they would undoubtedly have elected to adopt the on-cost system rather than the direct cost system, if I may put it in that way. They go into that at considerable length, and they undoubtedly come to the conclusion that they prefer the on-cost method. But I do not find that they ever contradict or go back upon their previous finding—never mind for the moment whether it be fact or law—that either the on-cost method or the direct cost method is permissible and consonant with Income Tax principle. That is their finding, however much they elaborate their preference for the on-cost method. I am quite prepared to accept that these Commissioners, had they been on the board of directors, would not have chosen as the existing board has chosen, but would have preferred the on-cost method. At considerable length the Commissioners

elaborate the advantages of the on-cost method. But, however convincing their encomiums of the on-cost method may be, it seems to me that the whole of the latter part of this Case is overshadowed by their quite definite finding that the accountancy profession as a whole—they do not use the word "unanimous" —is satisfied that either method is admissible. I am quite open to argument to satisfy me that the on-cost method has certain advantages; indeed, I might also be open to persuasion that it is the better of the two methods. But, in face of the definite finding of the Commissioners, it seems to me that that finding overshadows, colours and influences the latter part of their Stated Case. What they have really said is, "It is not a matter for us, but it is very much a matter of policy for the directors of the company". It does not seem to me that their own preference for the on-cost method ought to limit or throw doubt upon the findings to which I have already referred in dealing with the early part of the Stated Case. If we assume that these Commissioners think that the on-cost method is greatly to be preferred, and if that is their view, it seems to me that they are saying, "We do not agree with the evidence which was called before us". Be it remembered that the opening words of paragraph 7 (*b*) are:

> "On the evidence adduced before us we find . . . that the accountancy profession as a whole is satisfied",

and so on. If that is the position on the evidence, they cannot after that decide the case on their own predilections for one or the other method. They have to decide it on the evidence called before them.

There is no doubt whatever, having regard to the earlier passage which I read—perhaps with unnecessary emphasis or repetition—that the accountancy profession, which is after all the expert profession in this matter, is as a whole satisfied that either method will do. The fact that the Commissioners and the Inspector of Taxes or the Court or anyone else choose to prefer one or other is not admissible because, whatever view others may hold, it is found to be open to the directors of this Company to adopt one of the two permissible methods, and they have decided to adopt the one which is known as the direct cost method of valuing stock in hand, work in progress, and so forth.

As I said at the beginning of my judgment, I am troubled with this case because there are those quite definite findings which seem to make it a somewhat top-heavy Case, in that the Commissioners go on to enumerate the virtues of one of the two methods—which is quite admissible, of course—and then say that they prefer one to the other. At the end of the Case, we find the matter set out in this way. After going into the figures, which are not material at this stage, they say, at paragraph 22:

> "We found that all the items of the sub-division No. 2 of schedule 'A' . . . were 'factory overheads' "

to be charged, with some limited exceptions; and they go into that at some length, giving, I think, a very good demonstration of the difficulties of the on-cost system in businesses of this kind, showing whether it is to include idle time, repairs and maintenance, staff pensions, guarantee costs, and all the rest. One thing is fairly clear from the latter part of the Case, namely, that the on-cost method is not a simple way of dealing with the matter. Although in the opinion of many it can be more satisfactory, it is not said that it is very much better, or rather that the other has no merits. The finding is, "Let the directors choose. Here are two ways. We will demonstrate how difficult the on-cost method is"; but they say, making it perfectly clear in the latter part of their Case, that they themselves prefer the on-cost method.

(Vaisey, J.)

The Case ends by setting out the questions of law for the opinion of the High Court:

> "(1) whether, on the evidence and in view of our findings set out above, our decision that the on-cost method should be applied in arriving at the cost of work in progress for the purpose of computing the Company's Case I profits was erroneous in law; (2) on the basis that we were correct in applying the on-cost method, whether our decision as to what items should be included in arriving at cost on this method was erroneous in law."

The question propounded for the opinion of the Court begins, "on the evidence and in view of our findings set out above". I can come to no conclusion other than that the directors have elected to use the direct cost method of arriving at the value for Income Tax purposes of work in progress; and if I myself had been on the board of directors and had come to another conclusion and had preferred to use the on-cost method, in spite of all the difficulties, it would not, it seems to me, be open to argument. I am not here to tell the directors what it would be good for them to decide. If I have come to the conclusion that they have a right to decide as between the two methods, I think that my own view is irrelevant; and, with great respect to them, I think that the view of the Commissioners is equally irrelevant, considering that they came to the conclusion that it was not for them but for the board of directors to decide as between the two methods of valuation.

The way in which the case has come before me is most unfortunate, and I have wondered whether the proper course might not have been to send it back, but on reflection I could not quite see what direction I could give to the Special Commissioners if I did send it back. I cannot very well tell them to alter their findings of fact. I cannot very well tell them that their own opinions are irrelevant to the present problem. I cannot very well tell them that their Case is inconsistent in itself and ought to be redrafted from top to bottom; that would not be polite, and I do not think it is any business of mine to tell them any such thing. I cannot quite see, if the Commissioners had the Case back, what they could do or what they would try to do. Would they try to withdraw their findings of fact or their conclusions of law? Would they try to reconcile what I think are the irreconcilable passages in the Case, and, if they did try, would it be within their proper power to make the attempt? I think the Case Stated is one which I must accept as regards the findings. I do accept it, and I think that the result is that this appeal by the Company must be allowed.

Mr. Roy Borneman.—I ask that this appeal be allowed with costs, that the cross-appeal of the Crown be dismissed with costs; and in the two succeeding cases, which are Profits Tax cases on precisely the same point, I again ask that in the first of them, *Duple Motor Bodies, Ltd.* v. *Commissioners of Inland Revenue,* the appeal be allowed with costs, and in the second of them, the cross-appeal of the Crown, that it be dismissed with costs.

Mr. Geoffrey Cross.—That would be consistent with your Lordship's judgment, I agree.

Vaisey, J.—Yes. I am troubled with this case. If anyone thinks that anything which has fallen from me shows any degree of self-satisfaction or pleasure in the case, he is very much mistaken. If justice is not done by the Order which I have felt it my duty to make, I suppose other Courts will have power to correct me. I do not think that anybody—certainly not this Company—can think that it is a very satisfactory approach to the Court. As I say, if justice is not satisfied by the Order which I have made, I shall be glad to feel that there are methods of putting the matter right. I am much obliged to you both, Mr. Borneman and Mr. Cross, for the help you have given me. Could

your learned junior, Mr. Borneman, endorse his brief—I suppose he has four —so that we may know exactly what the proper form is? Should it be sent back to the Commissioners to adjust?

Mr. Borneman.—In the Stated Case they arrived at certain determinations with regard to the assessments and the figures of the assessments. That is paragraph 23. I should also ask your Lordship, I think, to send the Cases back to adjust all assessments in accordance with your Lordship's judgment.

Vaisey, J.—Yes, in accordance with my judgment, I think that should be done.

Mr. Cross.—Yes, my Lord. I am sure that there will be no difficulty in the figures.

Vaisey, J.—Yes, that is right.

Mr. Borneman.—I am sure that is right, my Lord, and there will be no difficulty in agreeing the figures.

Vaisey, J.—I can send it back to the Commissioners to amend their order in accordance with my judgment.

Mr. Borneman.—Your Lordship will not send it back. It will be remitted to the Special Commissioners to determine the figures in accordance with your Lordship's judgment.

Vaisey, J.—I think that is the proper course, yes; remit to the Commismissioners to adjust the figures in accordance with my judgment.

Mr. Borneman.—Yes, my Lord.

Vaisey, J.—Not a very satisfactory case, as I have said. However, there it is.

The Crown having appealed against the above decisions, the cases came before the Court of Appeal (Lord Evershed, M.R. and Pearce and Harman, L.JJ.) on 15th, 16th, 17th and 18th March, 1960, when judgment was given unanimously against the Crown, with costs.

Mr. F. N. Bucher, Q.C., and Mr. Alan Orr appeared as Counsel for the Crown, and Mr. Roy Borneman, Q.C., and Mr. C. N. Beattie for the Company.

Lord Evershed, M.R.—The question for the decision of this Court may be taken as it was formulated by the Special Commissioners at the end of the Case Stated. It is as follows:

> "whether, on the evidence and in view of our findings . . ., our decision that the on-cost method should be applied in arriving at the cost of work in progress for the purpose of computing the Company's Case I profits was erroneous in law".

The question as formulated did not (and, I will assume, deliberately did not) limit the subject-matter to the Company's Case I profits for particular years; but I wish to say at the beginning that the problem before the Special Commissioners and before us should be treated as so limited. At the beginning of the Case three years are referred to (though, for the purposes of this judgment and of the argument, one particularly has been mentioned), namely, the year 1951–52 and the two succeeding years. I repeat that I shall treat the question posed as relating to those three years. The Special Commissioners then put a second question, which I shall not read but to which I may make some brief allusion hereafter.

As appears from what I have already read, the question arises in connection with the computation of the profits of the Company, Duple Motor Bodies, Ltd., for the purpose of Income Tax under Case I of Schedule D. Put in the

(Lord Evershed, M.R.)

language of the Statute, which language is now enshrined in Section 127 of the Income Tax Act, 1952, the real question to which this matter is related is: For the years in question, what were the full amounts of the profits or gains of this Company's trade? Before the case of *Whimster & Co.* v. *Commissioners of Inland Revenue*, 12 T.C. 813, the profits or gains of a trade were, I understand, ordinarily arrived at, in the case of a company such as this, by discovering what the trading receipts were for the year in question and then deducting from those receipts the proper expenses which were allowable according to the Income Tax legislation. But since the *Whimster* case it has been recognised that, for the purpose of ascertaining the full amount of the profits or gains of a trade, it is (or, at any rate, it may be) necessary also to bring into the account, at the beginning and at the end respectively of the relevant period, the values of the work in progress or the stock-in-trade, or perhaps both; and that such values will, again in the ordinary case, be arrived at by looking at the market value or the cost, whichever is the less. The effect of bringing these matters into the account is this, that if at the end of the year the value of the work in progress or stock-in-trade is shown to be greater than it was at the beginning, then to that extent the full amount of the profits will be increased; and *vice versa* if, at the end of the year, the value of such items is less than it was at the beginning.

In the present case it is to be noted from the reading of the question that I have already made that we are here concerned not with stock-in-trade but with work in progress. The reason for that is the nature of this Company's business. As its name implies, its business is that of manufacturing motor bodies, and we were informed by Mr. Bucher in his opening that in truth the business wholly, or at any rate very substantially, consist of making these bodies to order. That being so, there would of course be no question of a market value for any bodies either partly finished or wholly finished but still on the premises of the Company; and that, indeed, is so stated in paragraph 11 of the Case Stated, where, in the course of formulating their decision, the Commissioners say:

> "it is agreed that there is no question before us of market value."

I can now state again, and more precisely, the nature of the question we have to decide, and I can further explain the reference to on-cost in the question as it was posed by the Special Commissioners. The problem is, in relation to this Company's trading for the years I have mentioned, how you should arrive at the value, at the beginning and end of the periods, of their work in progress. It appears quite clearly that in the profession of accountancy there are two methods or theories which are current, both of which appear to have their devotees. The methods or theories are known, the one as the "direct cost" method and the other as the "on-cost" method. The direct cost method, as the words naturally import, means that you value the subject-matter—in this case the work in progress—by looking, at the beginning and end of the relevant periods, at what has been expended on the work in progress, and expended exclusively upon it; namely, for practical purposes (or at any rate in this case) the cost of the materials used and the wages of the labour directly employed. The on-cost method goes further; it says that you should not exclude a proper proportion or other, more general, costs of the Company's business, some part of which should be attributed to the work which was in progress at the relevant dates.

When Mr. Bucher opened the case for the Crown before us, he made it plain that what the Crown desired was that we should decide this matter as one of broad principle: that, of the two champions being displayed before us,

we must decide as a matter of broad principle between Sohrab and Rustum. Similarly, Mr. Borneman, for the Company, invited us to decide that the direct cost method was the one that, generally speaking, should receive the imprimatur of this Court. In support of these views, general arguments were put before us which clearly have much force. It was said by Mr. Bucher that if you are enquiring what is the value of, say, stock-in-trade, and in the circumstances you are to arrive at it by looking at what it has cost you to produce it, then it is not realistic to exclude any part of the general costs of the Company's business, and so to do simply loads those costs unduly upon the sold articles. On the other side, Mr. Borneman has said that here you are only concerned to arrive at a valuation, and in doing so—because, after all, you are merely comparing two dates—it is only necessary and only safe to look at the costs which can be certainly discovered and ascertained, and that you should not go beyond that into territory which at once becomes vague and uncharted. He supports that by saying that in this case the Special Commissioners, having decided in favour of on-cost, were then unable to express any concluded view as to which of the possible items of indirect expenses are to be included.

The Special Commissioners were persuaded to deal with this matter as one of general principle, and they so stated; and, as a matter of general principle, they expressed their own preference, for reasons to which I shall very shortly allude, in favour of the on-cost method. In so far as they did that, it seems to me inevitable that they were not deciding a question of fact but a question of law, or, at least, of mixed law and fact. I am, for my part, quite clear that it would be wrong for this Court to deal with this matter as one of principle and to decide now that, either for all purposes of this Company or, still less, for all purposes in the case of trading companies, one method is the right and proper method and the other is not. So to do would, I think, go altogether outside the function of the Court, which is to decide the particular problem presented by the particular case before it. As Mr. Bucher more than once emphasised, that with which we are concerned, and only concerned, in this case is the full amount of this particular Company's profits or gains for tax purposes for certain years. Moreover, to decide the matter as one of principle, one way or the other, would, I think, fly in the face of what has been found to be professional opinion among chartered accountants. I would also add that I entertain the strongest inclination that if we were to decide now in favour of one champion rather than another, in a very short time a case would arise which would show quite clearly that on those facts the decision of this Court could not be right. I add also that if we were to decide in favour of the on-cost method as a general proposition, the result, so far as I can see, would at best be inconclusive; and certainly if we adopted the drawing of the line which was indicated by the Special Commissioners and which Mr. Bucher was inclined, I think, to accept, though he thought it was wrong, we should be giving our sanction to a purely arbitrary definition of the limits of indirect costs which should be taken into account. What we have to do, I repeat and emphasise, is to apply our minds to the question of the proper way of valuing work in progress at the beginning and end respectively of the three years with which we are concerned as it affects the profits or gains of Duple Motor Bodies, Ltd.

At this stage I will cite two statements which were cited by Singleton, L.J., in the case of *Patrick* v. *Broadstone Mills, Ltd.*, 35 T.C. 44, at pages 65 and 67 respectively. The first citation comes from the opinion of the Lord President (Clyde) in the *Whimster* case itself(1). It is as follows:

(1) 12 T.C. 813, at p. 823.

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> " 'In computing the balance of profits and gains for the purposes of Income Tax, or for the purposes of Excess Profits Duty, two general and fundamental commonplaces have always to be kept in mind. In the first place, the profits of any particular year or accounting period must be taken to consist of the difference between the receipts from the trade or business *during such year or accounting period* and the expenditure laid out to earn *those receipts*. In the second place, the account of profit and loss to be made up for the purpose of *ascertaining that difference* must be framed consistently with the ordinary principles of commercial accounting, so far as applicable, and in conformity with the rules of the Income Tax Act, or of that Act as modified by the provisions and schedules of the Acts regulating Excess Profits Duty, as the case may be. For example, the ordinary principles of commercial accounting require that in the profit and loss account of a merchant's or manufacturer's business the values of the stock-in-trade' "

—and I would add here, though it is not in the opinion, "or work in progress"—

> " 'at the beginning and at the end of the period covered by the account should be entered at cost or market price, whichever is the lower; although there is nothing about this in the taxing statutes.' "

The second citation is a brief citation from the speech of Lord Loreburn, L.C., in the case of *Sun Insurance Office* v. *Clark*, 6 T.C. 59, at page 75, where the Lord Chancellor said:

> " 'An estimate being necessary' "

—that is for the purpose of arriving at the value of the work in progress—

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

Founding myself upon those two citations, it seems to me that you proceed in this case, and in other cases, to say: What is the normal, proper, accounting practice in regard to this matter, and does what is normal produce a fair result? Or, if there are alternatives, which is shown on the facts of the particular case to produce the fairer result?

With that premise, I now turn to make one or two references to the Case Stated. In paragraph 7, the Special Commissioners, who are persons of great experience, refer to certain expert evidence given, and then, in sub-paragraph (*b*) they say:

> "On the evidence adduced before us we find, and this naturally has caused us difficulty, that the accountancy profession as a whole is satisfied that either method will produce a true figure of profit for Income Tax purposes."

Mr. Bucher somewhat criticised the addition of the last four words, but I do not think that criticism is justified. If either method is a proper method for arriving at profits for general commercial purposes, then it satisfies the test which is suggested by the Lord President (Clyde), but of course it still leaves it to be debated whether, in the particular circumstances of a particular case, it is fair

The Commissioners went on:

> "In this state of affairs we find that it is very much a matter of policy for the decision of the directors of a company which method should be used."

I shall come back to that presently; but a little lower down the Commissioners proceed to deal with the still more vexing problem, as they thought and as I think: If in any particular case you do choose the on-cost method, then what of the indirect costs do you include? As regards that, they said:

> "(*e*) If the on-cost method is applied, different accountants may apply different recognised variations of this method; and, whatever recognised variation of this method is applied, the accountancy profession as a whole would not condemn any particular recognised variation as being unsound. Furthermore, we find that there

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is considerable scope for difference of opinion as to how a recognised variation of the on-cost method should be applied to the facts of each particular case."

I pass at once to that part of the Case in which their decision is recorded, paragraph 11, and I will first of all read some four or five passages without comment. They begin:

"We have been asked to decide this appeal on a broad question of principle, and we are going to do that, fully aware that in doing so we shall be leaving open a wide field for discussion between the parties; but we feel that, having to decide this as a broad question of principle, that is really inevitable and cannot be helped."

Then, after stating what the problem was and referring briefly to certain arguments, they say:

"The Crown contend that some part of these overheads"

—that is, the general business overheads—

"must go into the cost of work in progress. When the factory is not running at full capacity, the Crown say, it is obvious that production costs more—that is, it costs more, if the factory is not running at full capacity, to make a particular vehicle. That is a fact, the Crown contend, and that kind of fact ought to be reflected in the accounts; and the on-cost method does reflect that kind of fact."

In the next paragraph they deal with the expert evidence, and as regards one of the accountants, Mr. Clark, they say:

"Mr. Clark's evidence comes really to this, that the two methods are both accepted in the accountancy profession, and that you cannot say there is a general opinion in the accountancy profession that the on-cost method is unsound. Mr. Clark told us that each method will produce a true view of profits for Income Tax purposes;"

—and I emphasise the last words, to show justification for what I have already read—

"and we think we might say here that we consider it important that ascertaining profits for Income Tax purposes does involve ascertaining profits year by year."

I should add that it had earlier appeared to have been Mr. Clark's evidence that although, as he stated, both methods were regarded as acceptable and proper, there seemed recently to be a swing against the on-cost method within the accountancy profession.

The Commissioners then say this:

"We feel in the end that to get at the true cost of producing an article—that is, the cost of making the thing—there is really something more in the cost than the mere cost of labour and the cost of the material that has gone into that particular article. It seems to us that it has really cost more to build a vehicle body than just the cost of labour and material. The object of the on-cost method —whether we are right or wrong about this—is really to get at the cost; and, as we are coming down on the side of the on-cost method, it appears to us that any proportion of overheads, which on that method is to be attributed to cost, should be limited to factory overheads, namely, the overheads of the place where the thing is actually being made. We realise that the expression 'factory overheads' is rather vague; but, since we are asked to decide this matter on a broad question of principle, we feel, as we have already said, that it is inevitable that a wide field for discussion should be left open, and we do not feel able to define the term 'factory overheads'."

They conclude:

"We finish where we began, by saying we know full well that we have left a wide area open. We do not think we can help that."

Now I cannot refrain from observing that it seems to me an obvious criticism of the Crown's argument that, if as a broad principle we must give our imprimatur to the on-cost method, then, according to the Special Commissioners, that leaves quite undecided (and, they thought, really incapable of

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decision) what are the exact items which should be included. That is not indirectly to say that I am intimating that the direct cost method is the proper method as a broad matter of principle; but it shows, what has been emphasised in the passages I have cited, that the Court should deal—and can only deal, as I think—with the particular circumstances of particular cases as a question of fact and figures, and say: On these facts, on these figures, is this way of doing it fair as between the Crown and the subject, or is that way the fair way of doing it?—and I do most strongly venture to emphasise that aspect of the matter.

The learned Judge, Vaisey, J., resolved the conflict in a different sense from that of the Special Commissioners. Mr. Bucher somewhat criticised his judgment, because he said that the Commissioners had found that it was proper accounting practice to use either method, whereas, said Mr. Bucher, what the Commissioners said was that they had found that the accountants were satisfied that it was proper to use either method; but, without repeating what I have already said, in my judgment that is exactly the same thing for this purpose, having regard to the Lord President's opinion(1). I do not, therefore, think, if I may say so, that there is anything in that criticism. On the other hand, I agree with Mr. Bucher that for Income Tax purposes you cannot say: "Well, it is a matter for the directors. If the directors had decided to adopt in a particular year or years the direct cost method, that concludes it for Income Tax purposes". The duty of the directors is to make their decision on this matter in the best interests of the Company, looking at it as a business entity; and quite plainly it could not be said that their conclusion, quite properly come to as responsible for the Company's management, was decisive of the matter for Income Tax purposes.

I have already said more than once—and I shall be forgiven because I wish to emphasise it as strongly as I can—that I think it is wrong, and would be wrong, to decide this matter on general principle. I base that view partly on the citations I have made from the *Broadstone Mills* case (2) and also as I have also intimated, on the results it would or might appear to lead to, of which the citations from the Case Stated will have given sufficient illustration. I take by way of example what was said in paragraph 10 (5). The Crown's contention, and I gather the Special Commissioners in some sense founded themselves upon this, was that obviously, if you are asking how much it cost to produce something, you should not exclude altogether overheads, and it is unrealistic to do so. But the conclusion of the passage I have read seems to me to be this, that if, as the Special Commissioners say, production is slack, it follows that the proportion of overheads attributable to the work in progress is larger, from which they apparently are led to the conclusion that the taxable profits are necessarily larger—a proposition which I venture to think is self-condemnatory.

But I return to the facts of this case, and what I have just said is, I think, a fitting prelude. There have been exhibited certain schedules, and I will make some reference to the figures. For the first year, ended 31st March, 1951, which has been the subject of debate—since, by Section 127 of the Income Tax Act, 1952, you look at the preceding year—you find this on the figures: the work in progress at the end of the year according to the Company's method of computation, based, that is, on direct cost, was worth £136,000 odd; at the beginning of the same year it was worth £138,000 odd. The result is that the work in progress was £2,000 less in value at the end of the year than at the beginning, with the result, no doubt, that the taxable profits would be reduced by £2,000.

(1) 12 T.C. 813, at p. 823. (2) 35 T.C. 44.

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The application for the same year of the on-cost method shows that if the sums are added, at the beginning and end of each year, which the Crown suggest should be added, however arbitrarily selected from overheads (and I repeat that the Crown seem to have accepted the arbitrary selection, though they said in the plainest language in opening the case that this geographical limitation is quite wrong), the curious result is that the value of the work in progress at 31st March, 1951, is not £2,000 less but £14,000 more than it was at the beginning of the year in question. So that, according to this computation, the full amount of the profits or gains to be taxed must be increased by £14,000 instead of being reduced by £2,000 in respect of that item.

Of course, if the truth is that upon a fair view the profits were £14,000 more and not £2,000 less, then it would be unfair that the tax liability should depend upon the latter and not the former calculation. But what evidence is there to show that the right view is that work in progress should be taken in at £14,000 more at the end than at the beginning? We have no idea, because there is, for example, no evidence whatever of the number of unfinished motor bodies that there were in fact on the Company's premises at the begining or at the end of the year in question. What we do know, however, is that during this year ended 31st March, 1951, there was a considerable slackening off of the Company's business. Whereas for the year ended 31st March, 1950, the wages paid to labour were £543,000 odd, for the year ended 31st March, 1951, it was £347,000 odd, nearly £200,000 less. I suppose that, as a Judge, I may take some account of the general knowledge that there has been no general tendency towards a reduction in wages, at any rate on that scale, during the past decade, and it therefore seems quite plain that there was far less work being done. That of itself, of course, supports what I indicated earlier, that the Special Commissioners seemed to be basing themselves on the passage I have read from the fourth paragraph of the Commissioners' decision, paragraph 11 of the Case Stated. They were saying that because, owing to a slackening off of business, a greater share of overheads must be applied to work in progress, the taxable profits of the Company were greater. I add only this, that in order to arrive at the figure for which the Crown contend, namely, £14,000 excess of value of work in progress at the end as compared with the beginning, the proportion of overheads taken in as at 31st March, 1950, was 27.9 per cent. of the whole, and at the end it was 40.5 per cent. The justification for these percentages has not been debated, but they make it perfectly plain that the increased value of the work in progress depends obviously on the fact that this Company was doing less work.

There was before us some discussion on the matter of onus of proof, and of course I accept it that where the taxpayer is assessed and complains that the charge made upon him is wrong, he must show it to be wrong; but also, as we all know, and as Mr. Bucher naturally and frankly conceded, in discussing the case the onus may shift from time to time from one party to the other. In considering the proper way to formulate a conclusion here, I venture to think certain facts are relevant in this particular connection. In the first place, it is conceded by the Crown that this Company and its immediate predecessor have been taxed upon the full amount of profits and gains, arrived at so as to include the value of work in progress calculated by reference to the direct cost method, for rather more than a generation; and throughout that period the Crown have accepted that method of arriving at the value, or the comparative values, of the work in progress, as being fairly represented by the application of the direct cost method. Further, as Mr. Bucher again frankly conceded, in

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the tax years with which we are concerned there was no relevant change of circumstances in this Company's general affairs at all. In those circumstances, I should have thought that at any rate there was some obligation upon the Crown to show why they have now come to the conclusion that the on-cost method should be adopted and the direct cost method should be discarded. What I have said perhaps supports the view that, for reasons which I assume may be quite good (at any rate, it is not a matter on which we have to express an opinion), it is thought that now is the time to strike a blow for the on-cost method in this sort of case. It may also support the view or the suspicion, which accounts for this matter of principle not having been raised before, that in the end of all (that is, over a period of years) it matters not at all which method is adopted; in the end of all, it comes to the same thing.

In the result, however, if on the figures, on the facts, on the evidence, it were necessary for this Court to reach an affirmative decision, I must say I would be prepared to conclude that for these particular years and in relation to this particular Company the on-cost method was shown to produce, on the face of it, an unfair result; but again let me say that this is not an oblique way of saying that I am affirming the view, as a matter of principle, that the direct cost method is the right one. In those circumstances I am, I think, quite content to put it in this way: referring back to the question posed by the Special Commissioners, which I need not repeat, I think that, in relation to the particular years and to this particular Company, which is the only matter with which this case is concerned, the decision of the Special Commissioners was wrong in law. Having come to that conclusion, I would therefore dismiss this appeal.

Pearce, L.J.—I agree. There is a divergence of view in the accountancy profession as to the respective merits and defects of the direct cost and the on-cost methods. The Commissioners were asked by both sides to regard this case as a conflict *à outrance* between the two methods, and to give their verdict to the winner. We, too, have been asked to give such a verdict, but it would be wrong to lay down such a general rule as if it were a matter of law. It is a question of fact in each case to ascertain the true profit.

The result has been that the ascertainment of the particular profits for the particular year, which, after all, was the real object of the enquiry, has been a little submerged by this ideological dispute. It must be remembered that the costing of the work in progress, though it is a necessary part of accounting both from a commercial point of view and, since the *Whimster* case (1), from the Income Tax point of view, is nevertheless only a means to the ascertainment of the profit and not an end in itself. Moreover, one year will correct the errors of another. And it would be unfortunate if dogmas of method obscured the real purpose—the finding of a fair, true and reasonable assessment of the real profit of the business for the year. Whatever the merits of the on-cost method as seen from one point of view, in a certain set of circumstances it can produce an unfair result. As the Master of the Rolls pointed out in argument, not only can it produce such a result, but that particular set of circumstances does apparently arise in this particular case. When a factory has an idle and unprofitable year, the costing of the work in progress is inflated by the fact that it has, under the on-cost method, to bear an abnormally high proportion of the overheads during an uneconomic period. As a result, the profits are notionally increased, whereas in fact there are no true profits to justify that increase. In such a case, an actual loss could be converted on paper into a theoretical and untrue profit.

Both theories rest ultimately on the fact that cost is a guide to value.

(1) 12 T.C. 813.

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When, owing to trade difficulties, cost parts company from value, difficulties arise, and it may well be that the more realistic the costing the greater the difficulty. It has been argued that an unfair result can always be avoided by the proviso that the market value can be taken as the touchstone wherever the on-cost calculation would produce too high a figure; but here it was common ground that the market value was not appropriate to the facts of this case. Here it would seem that a substantial amount of the figure added by the on-cost method is due to lack of work in the factory. The profits are thereby notionally increased owing to that unprofitable lack of work. That result, which, owing to the general nature of the argument, had not received the prominence to which it was entitled, must be of very great importance in these assessments; and once it is fully appreciated it becomes plain, in my view, that it would be wrong, in the circumstances of these particular assessments, in these particular years, to depart from the simpler, direct cost method that had always been used by this Company over so many years. For that reason, and for those that have been given in greater detail by my Lord, I agree that the appeal fails.

Harman, L.J.—I, too, agree. This case has been a good illustration of the sometimes forgotten fact that an English law suit is not a moot or a debate, but an attempt to arrive at a result on the facts before the Court. Broad academic arguments are quite unsuited to the processes of the English law.

Here, on-cost has been declared by the Commissioners to have their vote as a general matter, regardless of the fact that when the details are looked into it produces an absurdity. Judged by that touchstone, the Commissioners could not have come to the conclusion they did; but they were not looking at the facts, but at the theories which were so largely debated before them. The result is that, taking their eyes off the ball, so to speak, they came to a conclusion which is not, when the facts are looked at, tenable. The appeal must therefore be dismissed, though not quite on the ground on which the learned Judge below dismissed it, for he decided upon the footing that the directors had the right to choose the method of costing for Income Tax purposes. In fact, of course, they have the right to choose the method *vis-à-vis* their shareholders and for the good of the Company, but it cannot be that they are the arbiters when it comes to assessing the costs from an Income Tax point of view. It is, of course, well known that many things, reserves, and so on, which are not allowable as deductions for Income Tax purposes are proper deductions when setting out the profits of the Company. But although we do not agree with all the reasoning of the learned Judge, we do agree with his conclusion.

Lord Evershed, M.R.—Mr. Borneman, I gather that after the debate before Vaisey, J., it was suggested that your briefs, of which you then had four, I gather, should be endorsed. I think you probably have only two in this case.

Mr. Roy Borneman.—Two, my Lord, not four. I think that was wrong.

Lord Evershed, M.R.—Yes; there was a cross-appeal below. However, it does not matter. However many briefs you had, as I follow it, the substance was that the cases should go back to adjust the assessments in accordance with the judgment, and it was thought by you, I gather, that that would be right. If we just dismiss the appeal and leave it at that, would that be all right?

Mr. Borneman.—So far as we are concerned, my Lord.

Lord Evershed, M.R.—Do you agree, Mr. Bucher?

Mr. F. N. Bucher.—If your Lordship pleases. That would be a suitable Order for your Lordships.

Lord Evershed, M.R.—Very good. The judgments which have been delivered you will treat, then, as the judgments in both cases?

Mr. Bucher.—If your Lordship pleases.

Lord Evershed, M.R.—That is right, is it not?

Mr. Bucher.—Yes, my Lord.

Mr. Borneman.—The same principle applies, my Lord.

Lord Evershed, M.R.—Or do you want two Orders?

Mr. Borneman.—There would be two Orders.

Harman, L.J.—There will be two Orders, each dealing with one case.

Lord Evershed, M.R.—There will be two Orders; but, having delivered one judgment, you do not want anything else?

Mr. Borneman.—No, my Lord.

Mr. Bucher.—Your Lordships will dismiss them with costs?

Lord Evershed, M.R.—Yes. Is that right?

Mr. Bucher.—Yes. My Lords, I have an application to make, which I ought to make now. It is for leave to appeal to the House of Lords, if my clients are so advised. We have a finding of the Special Commissioners in our favour.

Lord Evershed, M.R.—I do not think you have.

Mr. Bucher.—Not wholly.

Lord Evershed, M.R.—Not at all, so far as fact is concerned. You have got a conclusion of law. However, Mr. Bucher, may I ask you, perfectly frankly —I am sure you will not mind—do you wish to invite the House to deal with this matter as a matter of principle?

Mr. Bucher.—I frankly answer your Lordship. I am quite sure we would ask them to do so, and that is why it is, with diffidence, of course, in view of your Lordships' judgments, that I make my application; but I must make it.

Lord Evershed, M.R.—Speaking without consultation with my brethren, as we do take a rather strong view that it is not right to deal with this sort of case on broad principle, I should have thought it would be desirable that, if you wish to proceed, you should apply to the House of Lords, because they will then say whether you would be entitled to do that. If you are not, I would have thought that this would then be treated simply as a conclusion of fact on the assessments of a particular company for three years, and you would not probably be very interested in going on, anyway.

Mr. Bucher. Yes, my Lord.

Pearce, L.J.—I entirely agree with what my Lord has said.

Harman, L.J.—I agree.

Lord Evershed, M.R.—I think we are all of that opinion. Would that not be best? We will formally say "No", and you can go to the House and can call attention to the fact that you wish to have this matter dealt with as a matter of principle, and that the Court of Appeal were very awkward about it and would not agree.

Mr. Bucher.—Not awkward, my Lord, but very firm. If your Lordship pleases.

On the petition of the Crown, leave to appeal against the above decision was granted on 16th May, 1960, by the Appeal Committee of the House of Lords (Lords Cohen, Keith of Avonholm and Denning), on the terms that

the Crown should undertake not to disturb the Order for costs below and, in any event, to pay reasonable costs in the House of Lords.

Mr. F. N. Bucher, Q.C., appeared as Counsel for the Crown, and Mr. Roy Borneman, Q.C., for the Company.

The cases came before the House of Lords (Viscount Simonds and Lords Reid, Tucker, Hodson and Guest) on 27th and 28th February, 1961, when judgment was reserved. On 28th March, 1961, judgment was given unanimously against the Crown, with costs.

Mr. F. N. Bucher, Q.C., and Mr. Alan Orr appeared as Counsel for the Crown, and Mr. Roy Borneman, Q.C., and Mr. C. N. Beattie for the Company.

Viscount Simonds.—My Lords, these appeals cannot, in my opinion, be sustained. They relate to assessments made upon the Respondent Company to Income Tax under Case I of Schedule D of the Income Tax Act, 1952, for the years of assessment 1951–52, 1952–53 and 1953–54, and to Profits Tax for the chargeable accounting periods between 1st April, 1950, and 31st March, 1952. The same questions arise in regard to all these assessments and it will be sufficient to take a single example, namely, the assessment to Income Tax for the year of assessment 1951–52. In that year the Respondent Company were assessed to Income Tax in respect of their trade of motor body builders in the sum of £250,000. They appealed to the Commissioners for the Special Purposes of the Income Tax Acts, who upheld the assessment but stated a Case for the opinion of the Court. The case came before Vaisey, J., who reversed the determination of the Commissioners. His decision was affirmed by the Court of Appeal.

The question at issue between the parties was as to the correct method of ascertaining the cost of work in progress in order to determine the full amount of the profits or gains of the Company's trade, and I will state at once the question as formulated in the Case Stated. It was:

> "whether, on the evidence and in view of our findings . . ., our decision that the on-cost method should be applied in arriving at the cost of work in progress for the purpose of computing the Company's Case I profits was erroneous in law".

This question was followed by another which, in the view that I take, does not arise. If it did arise, I do not think that there are materials which enable your Lordships to answer it. My Lords, it must be apparent that, before your Lordships can answer the question whether it was erroneous in law to apply the on-cost method for the purpose indicated, you must be told precisely what the on-cost method is. I doubt whether, at the end of two days' discussion, it is possible to form any clearer idea of it than that it is at least something different from the direct cost method, about which there is no less difficulty of definition. It was significant that learned Counsel, after arguing strenuously in favour of the on-cost method, invited your Lordships to assist the Crown by saying in what that method consisted. In these circumstances I would myself be content to dismiss this appeal upon the single ground that the Case Stated does not formulate a question which the Court can properly answer. I will, however, state certain further facts and make some observations upon them in deference to the arguments that we have heard.

The Respondent Company was incorporated in July, 1946, and took over the business of a company which had been incorporated in 1919. Its business is that of building to order bodies for different types of road vehicles, mostly

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motor coaches. As the business is almost entirely that of building bodies to order, very few finished bodies are included in work in progress at the end of an accounting period. The business is seasonal, the busy season ending about the end of June. The turnover of the business was over £1,000,000 per annum in the years 1948 to 1954. Upon these facts the question arises how for tax purposes (Income Tax or Profits Tax) the cost of work in progress, consisting of motor bodies, is to be ascertained.

I have referred to the two methods, direct cost and on-cost, and note that the Company and its predecessor had since 1924 been assessed on the former method until the assessments were made which are now in dispute. As these words are labels invented by accountants to describe two different methods, I will try to explain them, with the proviso that no explanation is precise or satisfactory. Before doing so, it is proper to say—it is, indeed, implicit in what I have said—that it is common ground that some value must be attributed to work in progress and that, in ascertaining that value, two considerations must be borne in mind: first, that the ordinary principles of commercial accounting must, as far as practicable, be observed and, secondly, that the law relating to Income Tax must not be violated (see *Whimster & Co.* v. *Commissioners of Inland Revenue*[1], 1926 S.C. 20)—that is to say, by one means or another the full amount of the profits or gains of the trade must be determined.

It is perhaps easier to say what the direct cost method means than the on-cost method. By that I mean that there appears to be less vagueness in the definition of that method. In the instant case, it seems that the Respondent Company has included nothing more in work in progress than wages and material directly attributable to that work. But that is by no means the end of the matter. For the Company, in the course of the case, has conceded that other items of expenditure might well be included. Direct cost therefore remains an imprecise term. The question of on-cost method presents far greater difficulties. Let me cite some passages from the Case Stated:

> "7. (*d*) There are several different ways of applying the on-cost method. Indirect expenditure is quite commonly divided by cost accountants into headings of: (*a*) factory expenses; (*b*) office expenses; (*c*) selling expenses; (*d*) dispatch and financial expenses. It is a common, but not universal, method of applying the on-cost method to include in the cost of work in progress a proportion of either all the factory expenses or of some only of them, and to exclude the other headings of indirect expenditure. (*e*) If the on-cost method is applied, different accountants may apply different recognised variations of this method; and, whatever recognised variation of this method is applied, the accountancy profession as a whole would not condemn any particular recognised variation as being unsound. Furthermore, we find that there is considerable scope for difference of opinion as to how a recognised variation of the on-cost method should be applied to the facts of each particular case."

My Lords, what a prelude is this to asking the Court whether the decision of the Commissioners that the on-cost method should be applied in arriving at the cost of work in progress in the present case was erroneous in law! I could understand it better if the question were whether the direct cost method could properly be applied. But it would not be much better.

The consideration of this problem undoubtedly presents something of a dilemma. The practice of accountants, though it were general or even universal, could not by itself determine the amount of profits and gains of a trade for tax purposes: see, for example, *Minister of National Revenue* v. *Anaconda American Brass, Ltd.*, [1956] A.C. 85, at page 102. On the other hand,

(1) 12 T.C. 813.

it was the basis of Lord President Clyde's decision in *Whimster's* case [1] that the ordinary principles of commercial accounting require that in the profit and loss account of a manufacturer's business the values of the stock-in-trade at the beginning and end of the period covered by the account should be entered at cost or market price whichever is the lower, although there is nothing about this in the taxing Statutes. It is for this reason that stock-in-trade (and work in progress also, though nothing is said of this in *Whimster's* case) is brought into account. If this is so, regard must be paid to accountancy principles also in ascertaining what that cost is, subject always to the condition that taxing Statutes must not be violated. As to this, let me cite some further passages from the Case Stated:

> "7. (*a*) Both methods are recognised by the accountancy profession as correct accountancy. . . . Professional accountancy opinion is rarely static on questions of this kind: we find that, up to fairly recently, the weight of accountancy opinion was in favour of the on-cost method, but that now the trend in the profession is slightly away from this method. (*b*) On the evidence adduced before us we find, and this naturally has caused us difficulty, that the accountancy profession as a whole is satisfied that either method will produce a true figure of profit for Income Tax purposes."

The final sentence is perhaps open to criticism, but I take it to mean that either method shows the full amount of the profits or gains of the trade, and I see no impossibility in this when I remember how elaborate and artificial are the methods of accountancy. The important thing is that the method which is in fact adopted should not violate the taxing Statute. Different results may be reached by different methods, neither of which does so.

My Lords, a first principle of tax law is that the taxpayer, in ascertaining his profit, is entitled to debit his expenditure in the year of assessment unless it is excluded by Section 137 of the Income Tax Act, 1952. And this is so although the whole of that expenditure may not bear fruit in that year: see, for instance, *Vallambrosa Rubber Co., Ltd.* v. *Farmer*, 5 T.C. 529. In other words, it is no ground for refusing a deduction in one year that the expense may be recoverable in another. Put in yet another way, the Crown is not entitled to anticipate a profit which may or may not be made, as it might do if too high a value were put on stock-in-trade or work in progress. This principle must be harmonised with another which I have already mentioned, namely, that at any rate *some* value must be placed on these things. That is recognised by the so-called direct cost method, even if it is confined to the cost of labour and material. But the danger of putting too high a value on stock-in-trade is also recognised, for, whatever method is adopted, the trader is by any theory of accountancy allowed to value it at cost or market value, which I take to mean market value at the end of the accounting period. This is of greater significance in the case of work in progress than of stock-in-trade. Counsel for the Crown admitted that the market value of an unfinished motor body made to order might be negligible but that, nevertheless, that value might be taken. Of this the Respondent Company may yet, I suppose, take advantage. They could not be blamed for doing so if the so-called on-cost theory is pressed to a manifestly unfair conclusion.

My Lords, I think that in this dilemma the prevailing consideration must be that the taxpayer should not be put to any risk of being charged with a higher amount of profit than can be determined with reasonable certainty. He may concede that stock-in-trade and work in progress must, for tax purposes, be regarded as a receipt. Upon that professional accountants appear to be universally agreed, though it might not be at once obvious to the layman.

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[1] 12 T.C. 813.

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But this concession should not be pressed beyond the point at which the profession is widely, if not universally, agreed; and I should, therefore, if I had to choose (which I have not) between two vaguely defined methods, choose the direct cost method as the less likely to violate the taxing Statute. I should be supported in this choice by the reflection that, if the cost is put at too low a figure, the error will be made good to the advantage of the Crown in the following year.

Another consideration that weighs with me is this. I recognise the force of the contention that if the cost of work in progress cannot be ascertained with accuracy, at least the attempt should be made to be as accurate as possible. But against this I put at least two powerful considerations. The first is that it is undesirable to indulge in what is no better than guesswork, though it may be described as an intelligent estimate; and it appeared to me that a large part of the suggested apportionment of overheads to stock-in-trade and work in progress was the wildest guesswork. It may be from the commercial point of view a desirable practice, but it is a very different thing to impose it upon a trader whether he wants it or not. It is not only unreliable for the purpose of ascertaining the year's profit, it is also an elaborate and costly practice if carried to its logical conclusion. And I see no reason why, once embarked on, it should not be carried to its logical conclusion. There appears to me to be no distinction, except perhaps of convenience, between the many varieties of cost which the exponents of one on-cost system or another advocate. A second and more powerful reason, which the case under appeal illustrates, is that an attempt to get as nearly as possible an accurate estimate of cost may, if it means the consistent application of a theory of costing, lead to what from the taxing point of view is an absurd conclusion. That is not too strong a word. For here, as was well pointed out by Lord Evershed, M.R., and Pearce, L.J., the value of the work in progress at the end of the relevant year was £2,000 less than at its beginning if the direct cost method is adopted, whereas according to the on-cost method it was not £2,000 less but £14,000 more. This difference is due to little else than the fact that the overheads had to be distributed among a smaller number of articles so that each of them bore a greater proportion of such costs. An idle and unprofitable year thus increases for tax purposes the value of the work that has been, or is in course of being, done. Counsel for the Crown did not shrink from this conclusion and accepted my suggestion that, if owing to a prolonged strike little work was produced, the weight of all the overheads would have to be thrown upon that little. The only course then open to the trader would be to take market value as the test. This, I have pointed out, is an invitation that may be accepted. My Lords, in my opinion this is fundamentally wrong. Stock-in-trade and work in progress are brought into account because, fictitiously but as a matter of plain common sense, they are treated as a receipt of the year's trading. The words "receipt" and "realised profit" were often on Counsel's lips in regard to them. My Lords, I would say, nevertheless, that it is something remote indeed from common sense to say that for taxing or any other purpose an inflated value is to be given to stock-in-trade or work in progress because a slump in trade has reduced the articles between which overhead costs can be apportioned. The asset, regarded as a receipt, is not more valuable, nor is a greater profit realised.

For the reasons that I have given I reject the so-called on-cost method as a method which can be imposed on the taxpayer. If, in any particular case, there is in the opinion of the Crown some item of expenditure beyond wages and cost of material which ought for tax purposes to be attributed to stock-

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in-trade or work in progress and there is a dispute about it, that can be settled in the ordinary way. But I will add, in order to show how impossible it is to lay down any universal or even general rule, that it may be equally open to the taxpayer in special circumstances to show that something less than the cost of material and wages should be taken as the value of work in progress or stock-in-trade.

I would dismiss this appeal with costs.

Lord Reid.—My Lords, the Respondents build bodies for motor vehicles: generally these are motor coach bodies built to order for individual purchasers. This case arises out of assessments to Income Tax in respect of that trade for the years 1951–52, 1952–53 and 1953–54. At the end of each accounting period the Respondents had in their possession a number of unfinished bodies on which work was proceeding, and which are referred to as work in progress. Admittedly, sums representing work in progress at the beginning and end of each period must be taken into account in computing the profits of the period for Income Tax purposes. The question at issue in this appeal is the principle by reference to which sums representing work in progress must be determined. In the Case Stated by the Special Commissioners it is said:

> "2. The questions for our determination were: (1) whether, in arriving at the cost of work in progress for the purpose of computing the profits of the Company for Income Tax purposes, the cost of direct materials and labour only ('direct cost') should be taken into account, or whether there should be added to the direct cost a proportion of indirect expenditure ('on-cost'); and (2) if on-cost was to be taken into account, what items of indirect expenditure fell to be included therein. It was common ground that there was no question of market value of work in progress, as it could not be regarded as saleable in its unfinished state.
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> "5. We were asked, in the first instance, to decide as a broad matter of principle whether the direct cost method or the on-cost method was to be applied in ascertaining the cost of work in progress for the purposes of computing the Case I profits; and on this basis we were asked to consider the accounts for the year to March, 1951, as an example."

The findings in the Case Stated may be more easily understood if I first set out what I believe to be the background of this matter. It appears that at one time it was common to take no account of the stock-in-trade or work in progress for Income Tax purposes; but long ago it became customary to take account of stock-in-trade, and for a simple reason. If the amount of stock-in-trade has increased materially during the year, then in effect sums which would have gone to swell the year's profits are represented at the end of the year by tangible assets, the extra stock-in-trade which they have been spent to buy; and similar reasoning will apply if the amount of stock-in-trade has decreased. So to omit the stock-in-trade would give a false result. It then follows that some account must be taken of work in progress. Suppose that the manufacture of an article was completed near the end of an accounting period. If completed the day before that date the article, if not already sold, has become stock-in-trade; if completed the day after that date, it was still work in progress on that date. It could hardly be right to take that article into account in the former case but not in the latter. I do not know when it became customary to take into account work in progress, but it appears that that has been customary for many years, and it is not disputed that, at least in all ordinary cases, that must now be done. Then the question is, what figure should be taken to represent the stock-in-trade. If it consists of articles bought for resale, the answer is obvious—the price the taxpayer paid for them, or their cost to him. If market value were taken, that would generally include an element of profit, and it is a cardinal principle that profit shall not be taxed until real-

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ised: if the market value fell before the article was sold the profit might never be realised. But an exception seems to have been recognised for a very long time: if market value has already fallen before the date of valuation so that, at that date, the market value of the article is less than it cost the taxpayer, then the taxpayer can bring the article in at market value and in this way anticipate the loss which he will probably incur when he comes to sell it. That is no doubt good conservative accountancy, but it is quite illogical. The fact that it has always been recognised as legitimate is only one instance going to show that these matters cannot be settled by any hard and fast rule or strictly logical principle.

The earliest authority dealing with this matter on general lines appears to be *Whimster & Co.* v. *Commissioners of Inland Revenue*, 12 T.C. 813. The opinion of Lord President Clyde has always been followed, and Lord Sands's opinion is also instructive. It is not disputed that the principles there expressed apply both to stock-in-trade and work in progress. But there was no discussion there as to the meaning of "cost", and that is the problem that now confronts your Lordships.

Broadly speaking, the direct cost method only takes account of money spent solely for the purpose of, or in connection with, the manufacture of the particular goods, whereas the on-cost method treats as an additional part of their cost proportions of various overhead expenses or of money spent in connection with the manufacture of those goods and also of others. The main elements in direct cost are labour and materials, though there may be others, and the method can be applied with a large degree of accuracy, but, as will appear in a moment, there is great uncertainty attaching to the on-cost method. The findings of the Special Commissioners with regard to these methods are long and elaborate, and I shall try to present them fairly in summarised form. Both methods are recognised by the accountancy profession as correct accountancy. Professional opinion is rarely static on such questions. The on-cost method is used for most taxpayers (it is not said whether any of them object to this). There are several different ways of applying the on-cost method: different accountants apply different recognised variations of it. Whatever recognised variation is applied, the accountancy profession as a whole would not condemn it. And within any particular recognised variation there is considerable scope for difference of opinion in its application to the facts of a particular case. The Commissioners quote from a booklet issued by the Institute of Chartered Accountants in England and Wales:

> "107 No particular basis of valuation is suitable for all types of business but, whatever the basis adopted, it should be applied consistently".

The present Respondents have used the direct cost method since 1924. There is one finding of the Commissioners which rather puzzles me.

> "7.(*b*) . . . the accountancy profession as a whole is satisfied that either method will produce a true figure of profit for Income Tax purposes."

This cannot mean that, taking a particular business in a single year, either method will produce a true figure: the methods will produce very different figures of profit and both cannot be true figures of profit for the same year. It may mean that, applied consistently over a period of years, both methods will for the whole period produce the same aggregate profit, and that appears to be approximately true. Or it may mean that one or other method will produce a true figure depending on the nature of the business, and that seems to accord with the "Recommendations" of the Institute.

Normally a Court attaches great weight to the view of the accountancy

profession, though the Court must always have the last word. But here the findings which I have summarised show that that assistance is not available on the issue which your Lordships have been invited to consider. The Commissioners state that they were asked to decide between these methods as a broad matter of principle, and your Lordships were also invited to take that course. But I find that very difficult: if the accountancy profession cannot do that, I do not see how I can. The most I can do is to try to bring common sense to bear on the elements of the problem involved in this case on the assumption, which I am entitled to make, that common sense is the same for lawyers as for accountants.

The Crown first submitted an argument which, if sound, would carry them a long way: indeed, it would carry them further than they wanted to go. It was based on an assumption that expenditure shown in a profit and loss account can all be divided into manufacturing and selling expenditure, and that the manufacturing expenditure can and should be attributed entirely to goods manufactured or partly manufactured during the year of account. If that were so, it might follow that you should allocate that expenditure between all those goods: if you refuse to allocate any of it to that part of the goods still unsold (stock-in-trade) or still unfinished (work in progress), you overload the goods already sold with more than their share and so reach a final figure less than the true profit. But the assumption is wrong. It has long been established that you are entitled to include in expenditure for the year all business expenses in that year not excluded by the old Rule 3 of the Rules applicable to Cases I and II of Schedule D, now Section 137 of the Income Tax Act, 1952, whether or not they can be attributed to the production of goods in that year. It matters not that certain expenditure may have proved abortive, or may have been spent solely with a view to production and profit in some future year and have no relation at all to production during the year of account. This was settled as long ago as 1910 in *Vallambrosa Rubber Co., Ltd.* v. *Farmer*, 5 T.C. 529, a decision often followed and never questioned. Expenditure which it is permissible to include in the account is the whole general expenditure during the period, and it can only be said to have been spent to earn the profits of that year in the sense that it was all spent during that year to keep the business going and that, during that year, the business yielded the profit shown in the account. So the question is not what expenditure it is proper to leave in the account as attributable to goods sold during the year, but what expenditure it is proper in effect to exclude from the account by setting against it a figure representing stock-in-trade and work in progress. You must justify what you seek to exclude in this way as being properly attributable to, and properly represented by, those articles.

I said that the Crown's argument would carry them further than they want to go. It appears from the Case Stated that expenditure is commonly divided by cost accountants into factory expenses, office expenses, selling expenses and dispatch and financial expenses. The Special Commissioners held that only factory overheads should be taken into account, and the Crown support their decision. I can see reasons why, in principle, selling and dispatch expenses should be excluded. But why exclude office and financial expenses? Some part, at least, of these may well have been closely associated with production. The Commissioners do not give any reason for including factory overheads and excluding the rest, and indeed they say that they do not feel able to define the term "factory overheads". I am not surprised. I can see that, if you are going beyond direct cost, there may be good practical reasons for drawing a line somewhere—going beyond it may be laborious and lead to

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insignificant results. The line may be drawn differently for practical reasons in different cases. But it would be impossible to say as a matter of principle that factory overheads must be brought in and others left out, and quite impossible to say so as a practical criterion if we do not even know how to define factory overheads. One can imagine many cases which would not fit any hard and fast rule or general principle. Suppose a new model is to be brought out which it is hoped to sell in large numbers over a period of years. Much preliminary work must be done before production starts, some of which might be factory overheads. For costing purposes I suppose that would be regarded as attributable to the new articles. But it is not so easy for Income Tax purposes. To begin with, preliminary work done in a previous year cannot be attributed to work in progress at the end of the next year. It went into the previous year's account and that is an end of it. And whether done in a previous year or in the same year, it was done partly with a view to producing articles already in course of manufacture at the end of the year and partly with a view to producing an unknown number of similar articles in future years. How much of it is to be attributed to the work in progress? As a practical matter some solution would no doubt be found. On principle the question seems insoluble.

It appears to me that we must begin at the other end and simply ask what, in all the circumstances of a particular business, is a figure which fairly represents the cost of stock-in-trade and work in progress. One thing clearly emerges as approved by the accountancy profession—whatever method is followed, it must be applied consistently. I accept that. So the real question is, what method best fits the circumstances of a particular business. And if a method has been applied consistently in the past, then it seems to follow that it should not be changed unless there is good reason for the change sufficient to outweigh any difficulties in the transitional year. In cases where the on-cost method has been consistently followed in the past there may or may not be good reason for changing now. There might, perhaps, be good reason for a change in a particular case in the other direction. But I can find nothing in the Case to justify such a change in the present case. That is not to say that every item in these accounts is in its proper place. It emerged that the cost of power used in making the unfinished bodies ought to have been, but was not, included in the cost of work in progress, and there may be other particular items in the same position. But I find nothing in the Case to support the Commissioners' decision to bring in whatever may be included in factory overheads. I am confirmed in this opinion by a consideration which greatly influenced the Court of Appeal. One of the findings in the Case is:

> "7.(*g*) One result of the on-cost method is that the cost of work in progress varies with the rate of production. If a factory is not working at full capacity, the cost of work in progress computed by this method is higher than if the factory is working at full capacity. On the direct cost method the cost of work in progress is not affected by the rate of production."

That means that, for a year in which trade is slack, the profits for Income Tax are inflated by the on-cost method because an unusually large proportion of factory overheads is attributed to work in progress at the end of the year, and its cost is therefore greater than it would have been if the factory had been busy. In costing for some purposes this may well be right, but it seems difficult to justify for Income Tax purposes. In many cases it must clearly be wrong if the whole year is taken as a unit. Suppose that the factory was losing money in the early part of the year but was busy in the latter part when the work in progress at the end of the year was in production. It could not be right to say that the cost of that work in progress should be increased because of

something that had ceased to have any influence before that work started. I would not go so far as to say that this consideration condemns the on-cost method in every case. No doubt all these methods have their weak points. But this does, to my mind, make it more than ever necessary to find good reason for adopting the on-cost method in any particular case.

One answer for the Crown was: Well, if the taxpayer does not like this inflated cost he can always elect for market value under the rule, cost or market value whichever is the lower. I am not satisfied that market value in its ordinary sense can be applied to work in progress. The rule "cost or market value" is not a substantive rule of law: it is a means of enabling the taxpayer to anticipate a loss by bringing expected loss into account. The taxpayer must be able, somehow, to do that in relation to work in progress, but it may be that some modification of the rule will have to be applied if the taxpayer can show that he has probably already incurred a loss in connection with his work in progress. In any case this is not, to my mind, an adequate answer to the difficulty.

The question stated in the Case is whether the Commissioners' decision that an on-cost method should be applied in this case is erroneous in law. I would answer that question in the affirmative on the ground that the facts and findings set out in the Case do not justify requiring the Respondents to change from their present practice of using the direct cost method. I am therefore of opinion that this appeal should be dismissed.

Lord Tucker.—My Lords, I agree that these appeals should be dismissed for the reasons stated in the opinion of my noble and learned friend, Lord Reid.

Lord Hodson.—My Lords, I also agree that these appeals should be dismissed for the reasons stated in the opinion of my noble and learned friend, Lord Reid.

Lord Guest.—My Lords, the contest between two different methods of costing for the purposes of Income Tax can seldom be resolved in the abstract by the Courts. It is only when these methods are applied to the facts of a given case that the Courts can give a satisfactory decision. But one essential factor which must be known is what is involved in each of these different methods. The Special Commissioners, in the present case, upon the invitation of the parties, attempted to decide as a question of principle between the direct cost method and the on-cost method in relation to work in progress. They favoured the on-cost method. They then proceeded to decide what items of expenditure were involved in the on-cost method. This was, to my mind, the wrong approach to the question and putting the proverbial cart before the horse. They ought first to have decided what items of expenditure were included in the on-cost method and then to have approached the problem of whether this method was the proper method of costing work in progress in the Respondents' factory. The Court of Appeal declined to treat the matter as one of principle, and for my part I think they were quite right to decline to do so. The Court of Appeal, however, while affirming the decision of Vaisey, J., did not approve of his ground of judgment, and again I think that the Court of Appeal were right. Vaisey, J., considered that, as the directors of the Respondent Company had elected to adopt the direct cost system in the preparation of the Company's accounts and as both the direct cost and the on-cost method were recognised by the accountancy profession as correct accountancy, the direct cost method was the proper method to apply. It can never rest with the taxpayer to decide upon what principle his income is assessed for tax purposes. The directors' decision can never be decisive of the matter for

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Income Tax purposes (see *Patrick* v. *Broadstone Mills, Ltd.*, 35 T.C. 44). The assessment, in addition to being consistent with normal accounting practice, must be made according to the provisions of the Income Tax Acts. The Court of Appeal held that, on the facts and figures, the on-cost method produced an unfair result and the direct cost method was the right one to apply. In these circumstances the burden is on the Crown to show that the direct cost method is not in accordance with the rules of the Income Tax Act, and as we were informed that the Crown have for a period of about 50 years accepted the direct cost method, and as this is the first case in which they have sought to set up the on-cost method as opposed to the direct cost method, this burden is a heavy one.

The proper approach to the matter was given by Lord President Clyde in *Whimster & Co.* v. *Commissioners of Inland Revenue*, 1926 S.C. 20, at page 25; 12 T.C. 813, at page 823:

> "In computing the balance of profits and gains for the purposes of Income Tax, or for the purposes of Excess Profits Duty, two general and fundamental commonplaces have always to be kept in mind. In the first place, the profits of any particular year or accounting period must be taken to consist of the difference between the receipts from the trade or business *during such year or accounting period* and the expenditure laid out to earn *those receipts*. In the second place, the account of profit and loss to be made up for the purpose of *ascertaining that difference* must be framed consistently with the ordinary principles of commercial accounting, so far as applicable, and in conformity with the rules of the Income Tax Act, or of that Act as modified by the provisions and schedules of the Acts regulating Excess Profits Duty, as the case may be. For example, the ordinary principles of commercial accounting require that in the profit and loss account of a merchant's or manufacturer's business the values of the stock-in-trade at the beginning and at the end of the period covered by the account should be entered at cost or market price, whichever is the lower; although there is nothing about this in the taxing statutes."

This statement of the law has in many subsequent cases been approved, and was in particular approved in *Minister of National Revenue* v. *Anaconda American Brass, Ltd.*, [1956] A.C. 85. The question is, therefore, whether the direct cost method is inconsistent with the ordinary principles of commercial accounting or is not in conformity with the rules of the Income Tax Acts.

The direct cost method only takes account of wages and materials in ascertaining the cost of work in progress. The on-cost method seeks to add to the figure arrived at by the direct cost method something in name of what may be compendiously called overhead expenses. The principle on which the Crown contend for the on-cost method was stated by Mr. Bucher as follows:

> "Where expenditure in the year includes expenditure on goods not sold during the year, this expenditure must be eliminated in order to get the true manufacturing cost of the goods sold during the year. The expenditure so to be eliminated is the total of all expenses which are incurred for the purpose of producing unsold goods and which would be factors in consideration of the market value of unsold goods."

This statement makes it clear that the Crown are not so much interested in altering the method of costing work in progress as in making an alteration in the deductible expenses in the Company's accounts. It is at once obvious that, by adding a sum in name of overhead expenses to the cost of work in progress, the Crown are *pro tanto* reducing the expenditure which would otherwise appear on the debit side of the accounts. The principle contended for is no justification, in my view, for adopting the on-cost method in relation to work in progress. No other justification in principle was put forward for the on-cost method. Moreover, the on-cost method, in my view, offends against the rules

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contained in Section 137 of the Income Tax Act, 1952, whereby the deductible expenses include all expenses wholly or exclusively laid out for the purposes of the trade. The adoption of the on-cost method involves the re-charging of the taxpayer by the disallowance of items of expenditure which are otherwise deductible under Section 137. It is a familiar principle of Income Tax law that the expense lies where it falls; that is, in the year in which it was incurred (see *Vallambrosa Rubber Co., Ltd.* v. *Farmer*, 5 T.C. 529, *per* Lord President Dunedin at page 534). By a circuitous method the Crown are attempting to disallow an expense which is otherwise deductible under Section 137. It is no justification, in my opinion, for allocating various items of expenditure contained in the accounts and relating them to the cost of work in progress on the plea that the expenditure is indirectly referable to the production of the work in progress. In *Naval Colliery Co., Ltd.* v. *Commissioners of Inland Revenue*, 12 T.C. 1017, Rowlatt, J., said, at page 1027:

> "Now, one starts, of course, with the principle that has often been laid down in many other cases—it was cited from *Whimster's* case[1], a Scotch case—that the profits for Income Tax purposes are the receipts of the business less the expenditure incurred in earning those receipts. It is quite true and accurate to say, as Mr. Maugham says, that receipts and expenditure require a little explanation. Receipts include debts due and they also include, at any rate in the case of a trader, goods in stock. Expenditure includes debts payable; and expenditure incurred in repairs, the running expenses of a business and so on, cannot be allocated directly to corresponding items of receipts, and it cannot be restricted in its allowance in some way corresponding, or in an endeavour to make it correspond, to the actual receipts during the particular year. If running repairs are made, if lubricants are bought, of course no enquiry is instituted as to whether those repairs were partly owing to wear and tear that earned profits in the preceding year or whether they will not help to make profits in the following year and so on. The way it is looked at, and must be looked at, is this, that that sort of expenditure is expenditure incurred on the running of the business as a whole in each year, and the income is the income of the business as a whole for the year, without trying to trace items of expenditure as earning particular items of profit."

It is the expenditure of running the business as a whole in each year which is to be looked at, not the expenditure related to any particular item of profit. If, of course, any expenditure can be directly related to work in progress, then this would fall to be added to the cost on the direct cost method. But no such question arises in this case.

In considering whether the on-cost method is a proper method I am influenced by a reflection of some of the absurd results which would follow from the adoption of this system. If the overhead expenses are to be allocated to the work in progress it will follow that, if trade is slack during any given year, a greater proportion of the overheads will be allocated to the work in progress; and, as the cost of the work in progress is to appear as an item of profit, this will swell the profits of the business. So this absurd result will follow, that when trade is slack the trader's profit on the goods sold will be low as his expenses are high, but his profit in respect of work in progress will be increased. I cannot think that a method which leads to these absurd results is in accordance with the principles of Income Tax law or, I may add, with common sense. I turn now to the direct cost method, which is limited to the cost of labour and materials. Have the Crown shown that this method is either inconsistent with the ordinary principles of commercial accounting or not in conformity with the rules of the Income Tax Acts? The Commissioners have found as a fact that the direct cost method is recognised by the accountancy profession as correct accountancy, and that it will produce a true

(1) 12 T.C. 813.

(Lord Guest)

figure of profit for Income Tax purposes. This method, therefore, satisfies Lord Clyde's first test. It is said that this method, like the on-cost method, offends against the principles enshrined in Section 137 of the Income Tax Act, 1952. But, according to the decision in *Whimster*(1), the cost of the work in progress must be ascertained, if it is lower than the market value. Work in progress is a receipt of the business as a result of work done during the year. The direct cost method ascertains the amount which the production of work in progress has actually cost. It does not, in my view, offend against Lord Clyde's second test.

The Crown have failed, in my opinion, to show that the on-cost method is of universal application. The Commissioners say that the accountancy profession is divided upon the question as to which is the proper method. The Crown have also failed to show that, in order to conform with the rules of Income Tax law, the on-cost method must be employed. Their appeal must therefore fail. Upon what is the proper method of costing to adopt in this case I need say no more than this, that upon the facts and figures the Respondents' profits have, in my opinion, been correctly assessed by the application of the direct cost method.

I would dismiss the appeal.

Questions put:

That the Orders appealed from be reversed.

The Not Contents have it.

That the Orders appealed from be affirmed and the appeals dismissed with costs.

The Contents have it.

[Solicitors:—Wilkinsons; Solicitor of Inland Revenue.]

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(1) 12 T.C. 813.

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