For the reasons which I have just given, and for the reasons given by Kerr L.J. in greater detail in his judgment, I would therefore dismiss this appeal.

Appeal dismissed with costs.
Order for costs not to be enforced without further order.
Leave to appeal refused.

Solicitors: Franklin, Piggott & Curtin, Banbury; Shoosmiths & Harrison, Banbury.

A. R.

[CHANCERY DIVISION]

*R.T.Z. OIL AND GAS LTD. v. ELLISS (INSPECTOR OF TAXES)

1987 April 29, 30; May 1; June 18 — Vinelott J.

Revenue—Corporation tax—Expenses of trade—Consortium licensed to win oil from North Sea hiring rig and tankers—Liabilities on closing down oil field—Inclusion of share of anticipated close-down costs in annual accounts—Whether capital or revenue expenditure—Whether deductible in computing liability to corporation tax—Income and Corporation Taxes Act 1970 (c. 10), s. 130(f)

The taxpayer company was a member of a consortium established in 1965 that was granted a licence to search for and exploit oil found in the Argyll field of the North Sea. The terms of the licence provided that when the consortium abandoned activities in the field it was to cap all oil wells and remove all oil-gathering equipment from the sea bed. In 1975, when the consortium commenced oil production, it was thought that the production life of the Argyll field would be only three years. The production was achieved by means of an anchored semi-submersible drilling rig that was hired by the consortium and which had to be restored to its original condition before being returned to its owner. Additionally the consortium chartered two tankers that were modified to transport the oil won ashore. It was a term of the charterparties that the tankers would be restored to their original condition on termination of their hire. It was clear that when production of oil from the field was exhausted the taxpayer company together with other members of the consortium would be faced with substantial expenditure on fulfilling the obligations that they had undertaken. Accordingly the taxpayer company decided to make annual provision for its anticipated share of that estimated expenditure in its profit and loss accounts, taking September 1978 as the projected close-down date for the field. For its accounting periods to 31

December 1976 and 31 December 1977 it included in its accounts provisions for expenditure on closing down the field that included the costs of clearing the sea bed and reconverting the drilling rig. In the latter period it also included its anticipated share of the cost of reconverting the tankers. Subsequently the projected close-down date for the field proved to be wrong and oil continued to be produced from the field. The taxpayer company appealed to the special commissioners against an assessment to corporation tax for the accounting period to 31 December 1977 claiming that the estimated expenditure on reconverting the rig and the tankers and on clearing the sea bed was deductible in computing its liability to corporation tax for the period. The commissioners dismissed the appeal in principle upholding the Crown's case that the expenditure when incurred would be of a capital and not a revenue nature and was not deductible by virtue of the provisions of section 130(*f*) of the Income and Corporation Taxes Act 1970.[1]

On appeal by the taxpayer company:—

Held, dismissing the appeal, (1) that the drilling rig and the tankers formed a part of the taxpayer company's profit-making apparatus, being the means which had to be provided for extracting the oil; that had any expenditure been incurred on purchasing such apparatus it would have been expenditure of a capital and not of a revenue nature; that no distinction could be made because the rig and tankers were made available to the consortium under non-assignable contracts of hire that were in themselves clearly capital assets; and that, accordingly, any future reconversion cost would be, as the original adaptation costs were, expenditure of a capital nature and not deductible in computing corporation tax liability (post, pp. 1453E—1454A, E–F, 1458B–C).

(2) That the oil-gathering equipment on the sea bed also formed part of the profit-making apparatus and thus the costs of removing it on close down, being expenditure that the consortium under the terms of the licence had agreed to incur in the future, was likewise expenditure of a capital nature that was precluded from deduction by section 130(*f*) of the Income and Corporation Taxes Act 1970 (post, pp. 1454F–H, 1456A–E).

The following cases are referred to in the judgment:

Addie (Robert) & Sons' Collieries Ltd. v. Inland Revenue Commissioners, 1924 S.C. 231; 8 T.C. 671

Alianza Co. Ltd. v. Bell [1906] A.C. 18; 5 T.C. 172, H.L.(E.)

British Insulated and Helsby Cables Ltd. v. Atherton [1926] A.C. 205; 10 T.C. 155, H.L.(E.)

B.S.C. Footwear Ltd. v. Ridgway [1972] A.C. 544; [1971] 2 W.L.R. 1313; [1971] 2 All E.R. 534; 47 T.C. 495, H.L.(E.)

Hallstroms Pty. Ltd. v. Federal Commissioners of Taxation (1947) 72 C.L.R. 634

Odeon Associated Theatres Ltd. v. Jones [1971] 1 W.L.R. 442; [1971] 2 All E.R. 407; [1973] Ch. 288; [1972] 2 W.L.R. 331; [1972] 1 All E.R. 681; 48 T.C. 257, C.A.

Pitt v. Castle Hill Warehousing Co. Ltd. [1974] 1 W.L.R. 1624; [1974] 3 All E.R. 146; 49 T.C. 638

Pyrah v. Annis & Co. Ltd. [1957] 1 W.L.R. 190; [1957] 1 All E.R. 196; 37 T.C. 163, C.A.

[1] Income and Corporation Taxes Act 1970, s. 130: "Subject to the provisions of the Tax Acts, in computing the amount of the profits or gains to be charged under Case I or Case II of Schedule D, no sum shall be deducted in respect of— . . . (*f*) any capital withdrawn from, or any sum employed or intended to be employed as capital in, the trade, profession or vocation, but so that this paragraph shall not be treated as disallowing the deduction of any interest."

Southern Railway of Peru Ltd. v. Owen [1957] A.C. 334; [1956] 3 W.L.R. 389; [1956] 2 All E.R. 728; 36 T.C. 602, H.L.(E.)
Strick v. Regent Oil Co. Ltd. [1966] A.C. 295; [1965] 3 W.L.R. 636; [1965] 3 All E.R. 174; 43 T.C. 1, H.L.(E.)
Sun Insurance Office v. Clark [1912] A.C. 443; 6 T.C. 59, H.L.(E.)
Sun Newspapers Ltd. v. Federal Commissioner of Taxation (1938) 61 C.L.R. 337.
Tucker v. Granada Motorway Services Ltd. [1979] 1 W.L.R. 683; [1979] 2 All E.R. 801; 53 T.C. 92, H.L.(E.)
Whitehead v. Tubbs (Elastics) Ltd. (1984) 57 T.C. 472 C.A.

The following additional cases were cited in argument:

Ammonia Soda Co. Ltd. v. Chamberlain [1918] 1 Ch. 266
Anglo-Persian Oil Co. v. Dale [1932] 1 K.B. 124; 16 T.C. 253, C.A.
Bonner v. Basset Mines Ltd. (1912) 6 T.C. 146
Coltness Iron Co. v. Black (1881) 6 A.C. 315; 1 T.C. 287, H.L.(E.)
Commissioner of Taxes v. Nchanga Consolidated Copper Mines Ltd. [1964] A.C. 948; [1964] 2 W.L.R. 339; [1964] 1 All E.R. 208, P.C.
E.C.C. Quarries Ltd. v. Watkis [1975] 3 All E.R. 843; 51 T.C. 153
Golden Horse Shoe (New) Ltd. v. Thurgood [1934] 1 K.B. 548; 18 T.C. 280, C.A.
Heather v. P.-E. Consulting Group Ltd. [1973] Ch. 189; [1972] 3 W.L.R. 833; [1973] 1 All E.R. 8; 48 T.C. 293, C.A.
Henriksen v. Grafton Hotel Ltd. [1942] 2 K.B. 184; [1942] 1 All E.R. 678; 24 T.C. 453, C.A.
Imperial Tobacco Co. (of Great Britain and Ireland) Ltd. v. Kelly [1943] 2 All E.R. 119; 25 T.C. 292, C.A.
Inland Revenue Commissioners v. Carron Co., 1968 S.C. 47; 45 T.C. 18, H.L.(Sc.)
Kelsall Parsons & Co. v. Inland Revenue Commissioners, 1938 S.C. 238; 21 T.C. 608
Mallett v. Staveley Coal & Iron Co. Ltd. [1928] 2 K.B. 405; 13 T.C. 772, C.A.
Morant (Surveyor of Taxes) v. Wheal Grenville Mining Co. (1894) 3 T.C. 298
O'Grady v. Bullcroft Main Collieries Ltd. (1932) 17 T.C. 93
Addie & Sons, In re (1875) 2 R. (Ct. of Sess.) 431; 1 T.C. 1
Southern v. Borax Consolidated Ltd. [1941] 1 K.B. 111; [1940] 4 All E.R. 412; 23 T.C. 597
Van den Berghs Ltd. v. Clark [1935] A.C. 431; 19 T.C. 390, H.L.(E.)
Wakefield Rural District Council v. Hall [1912] 3 K.B. 328; 6 T.C. 181, C.A.

CASE STATED by the Commissioners for the Special Purposes of the Income Tax.

The taxpayer company, R.T.Z. Oil and Gas Ltd., appealed against certain assessments to corporation tax, one of which related to its accounting period to 31 December 1977. In relation to that assessment the commissioners stated that the question for their determination was whether a provision of £733,649 made by the taxpayer company in its accounts for that period and which related to the anticipated costs of the future complete or partial termination of its operation in the Argyll oil-field was deductible by the taxpayer company in computing its profits chargeable to corporation tax under Case I of Schedule D. The commissioners concluded the appeal against the taxpayer company holding that deduction was precluded by the provisions of section 130(*f*) of the Income and Corporation Taxes Act 1970.

The taxpayer company appealed.
The facts are set out in the judgment.

John Gardiner Q.C. and *Peter Trevett* for the taxpayer company.
Andrew Park Q.C. and *Alan Moses* for the Crown.

Cur. adv. vult.

18 June. VINELOTT J. read the following judgment. This is an appeal by case stated from a decision of the special commissioners. The question is whether a provision in the accounts of the appellant taxpayer company, R.T.Z. Oil and Gas Ltd., for the accounting periods to 31 December 1976 and 31 December 1977 made to meet the estimated costs which at some future date will have to be incurred in dismantling structures installed for and reconverting equipment converted for use in the extraction of oil from the Argyll oilfield in the North Sea is an allowable deduction in calculating the profit (or, in the case of the accounting period to 31 December 1976, the loss available to be carried forward) derived from the trade or business of extracting oil from the Argyll field.

The factual background is unusually complex. It is explained in the admirably clear and comprehensive decision of the commissioners which is set out as an appendix to the case. In order to make this judgment intelligible a comparatively short summary will suffice. I will summarise the background facts under a number of short paragraphs.

The licence

In 1965 Rio Tinto Zinc Corporation Ltd. became a member of a consortium which had been established to search for and if found to exploit oil in the North Sea. It acquired a licence to exploit the oil in the Argyll field. Under the consortium agreement Rio Tinto Zinc Corporation Ltd. became entitled to a 25 per cent. interest in that field. By an assignment dated 28 April 1975 its 25 per cent. interest was assigned to the taxpayer company, which is its wholly-owned subsidiary, with effect from 31 December 1974. The licence to exploit the Argyll field incorporates the model clauses in Part II of Schedule 2 to the Petroleum and Submarine Pipe-Lines Act 1975. Paragraph 17 of the model clauses provides, among other things, (a) that the licensee shall not commence or after abandonment recommence drilling any well without the consent of the relevant minister, (b) that the licensee shall not abandon any well without the consent of the minister, (c) that the licensee shall ensure compliance with any conditions subject to which any such consent was given, (d) that the plugging of any well shall be done in accordance with a specification approved by the minister, and (e) that any well drilled by the licensee which on the expiry of the licence has not been abandoned shall be left in good order and fit for further working or if the minister shall so direct plugged and sealed in accordance with his direction. The consortium employed a company, defined in the decision as "the operator," to supervise the operations undertaken by the consortium. The operator carried out its functions as agent for each member of the consortium, each member being liable for a due proportion of the expenditure. The members of the consortium were not partners.

The rig

The Argyll field was the first North Sea oilfield to commence production. Production commenced on 11 June 1975. However, the field is or was at first thought to be a small field, the smallest in the North Sea. The geological formation in which the reservoir of oil is to be found creates problems in the extraction and in the estimation of the recoverable reserves of oil. For these reasons a means of winning the oil was adopted which has not been adopted elsewhere in the North Sea. Elsewhere a fixed platform has been erected. Wells are drilled direct from the platform. The wells are then connected to the platform by flexible pipes or flow lines. The flow of oil along the flow lines is controlled from the platform. The separation of the oil from the water and gas takes place on the platform. Because it was thought that the Argyll field might have a brief or doubtful life and a modest production the members of the consortium were reluctant to incur the expense of constructing a fixed platform. Instead it was decided to anchor a semi-submersible drilling rig modified so as to form a production platform from which the flow of oil could be controlled and on which oil could be separated from water and gas. However, wells cannot be bored from a floating platform. Instead, a drilling rig was brought into the Argyll field. When a well has been bored a well head is installed at the top of the well. The well head stands clear of the sea bed. The necessary apparatus for controlling the flow of oil is incorporated in the well head but is operated from the rig. Flow lines and control lines lead from the well head to a manifold anchored to the sea bed immediately beneath the platform. The oil from all the well heads is then passed by a central flow line to the platform, where water and gas are separated from the oil, the gas being flared off.

The consortium, through the operator, decided to hire rather than to buy a drilling rig for conversion into a production platform. The contract of hire was entered into on 23 July 1974. Under the terms of the contract the rig (No. TW 58) was to be towed to a North Sea port and modified at the operator's expense. The operator had the right to use the modified rig as a production platform for an initial period of 18 months measured from the completion of the work of drilling wells which had then been contracted for. At the end of that period the rig was to be towed to a North Sea port and restored to drilling condition, again at the operator's expense. Later, when the future of the Argyll field was more certain, a further contract dated 1 June 1976 was entered into. Under that contract the operator was given the right to use the converted rig for a further term of five years (then thought to be a period which would cover the life of the Argyll field) subject to the same obligation to restore to drilling condition. That five-year period has long since expired but the hire of the rig has been extended from time to time on the same terms. The Argyll field is still in production and the original floating platform is still in use.

The tankers

In the case of most, though not all, North Sea oilfields the oil is taken from the production platform to the onshore refinery or storage by a pipeline laid on the sea bed. Because the Argyll field was expected to be comparatively small and because its productive life was uncertain it was decided not to incur the expense of laying a pipeline but instead to use tankers to transport the oil. That required the installation of a

single buoy mooring for the tankers used to transport the oil. The oil is fed by a loading line from the floating production platform through the manifold to the single buoy mooring. Tankers have to be modified for offshore loading. The modifications include, first, cutting away part of the forward bulwarks to take a mooring line which holds the tanker in position while oil is being loaded and ensures that no tension is placed on the loading line, and, secondly, the strengthening of the foredeck to take an elaborate winch designed to control the tension on the mooring line and a crane to pick up the loading line.

Initially the operator chartered a single tanker, the *Theogennitor,* and modified it for use in transporting oil from the Argyll field. That was unsatisfactory because production had to be halted while the tanker was unloading. In the spring of 1976 the operator chartered two tankers, the *Leonidas* and the *Spiros,* and dispensed with the *Theogennitor,* which was restored to its original state before being handed back. The *Leonidas* charterparty is dated 9 March 1976. It is in a standard printed form with typewritten modifications. The initial hire was for 18 months. Under the printed terms the operator has the right with the owner's consent to modify the vessel to meet its loading and unloading requirements subject to restoration of the vessel to its original condition at the termination of the period of hire. That is modified by a typescript amendment permitting the operator to modify the vessel for its North Sea trade with liberty to remove any equipment installed on condition that the vessel is restored at the end of the period of hire to its original state. A further typescript amendment provides that if the owner is willing to retain the new equipment on board the operator shall have the option to redeliver the vessel "as is." The *Spiros* charterparty, which is dated 9 April 1976, is in substantially the same terms. Again these charterparties have been renewed from time to time and the vessels were still on hire on the same terms at the time of the hearing before the commissioners. Indeed, I understand that they are still on hire.

The abandonment costs

It is common ground that when the Argyll field is exhausted the taxpayer company and the other members of the consortium will be faced with very considerable costs. The tankers and the floating platform will have to be reconverted. There was evidence, accepted by the commissioners, that there was no real possibility that the owners of the tankers would be willing to take them back "as is." As regards the rig, a floating production platform is only used in one other North Sea oilfield, the Buchan oilfield, which was not in operation when the commissioners gave their decision. There was evidence, accepted by the commissioners, that if it were decided to use a floating production platform in any future oilfield the operator or consortium would almost certainly want to design their own platform or the modifications to be made to a drilling rig (if used) so as to take advantage of experience gained in producing oil in the North Sea. It is common ground also that the minister will have power under the licence to require, and will require, the consortium to cap all production wells and to remove the well heads, the manifold and loading buoy and the flow and loading lines, all of which have been collectively referred to as "the clutter." They would otherwise constitute an obstruction and a hazard to navigation and to fishing.

No provision was made to meet this future cost in the accounts of the taxpayer company for the year to 31 December 1975, which is the

year when production commenced. Those concerned concentrated on bringing the oilfield into production. However, during the course of 1976 the board of directors became aware that these heavy costs would have to be met and instructed the operator to supply detailed estimates. In the autumn of 1976 the board of directors of the taxpayer company decided in the light of those estimates that an annual provision should be made starting with the year to 31 December 1976. The provision was made in the following way. I will set out the figures to the nearest thousand dollars or pounds sterling. The operator's estimate of the cost of capping and abandoning the wells then drilled, of removing the clutter and reconverting the floating platform to a drilling rig was approximately $11.233 million. The close-down date was taken to be 30 September 1978. A calculation of the escalation of costs through inflation over this period was added. The total—approximately $13.480 million—was then converted into sterling at the estimated conversion rate on 30 September 1978. That gave a total of approximately £8.425 million, of which the taxpayer company's 25 per cent. share was approximately £2.106 million. As it was then expected that the cost of abandonment would have to be met in the comparatively near future the cost was not discounted. An estimate was made of the production of the Argyll field up to its close-down (approximately 16.3 million barrels) including its actual production in 1976 (approximately 8.3 million barrels). The proportion of the total expected production for 1976 and subsequent years attributable to the oil produced in 1976 was then applied to the taxpayer company's proportion of the total close-down costs. The resultant provision was approximately £1.070 million.

This process was repeated in 1977. However, during 1976 the *Theogennitor* had been replaced by the *Leonidas* and the *Spiros*. It was reconverted before being handed back to the owners at a cost of $320,000, which was debited to profit and loss account as part of the cost of operating the tanker. In view of the heavy cost incurred the board decided that the cost of reconverting the tankers which replaced it should be added to the cost of abandoning the Argyll field for the purpose of calculating the provision to be made in the accounts for 1977. The board also decided to add to the cost of abandonment the cost of insuring the rig and the clutter while the work was being carried out. A further estimate of the total cost of abandonment was produced by the operator. The total, including these additional items and the cost of capping five wells as against the four which had been drilled before 31 December 1976, but again without discounting for the period to the date when the cost was expected to be incurred, was $13.300 million. The addition to be made for inflation was calculated on the assumption that the close-down date would be 31 March 1979, as compared with 30 September 1978 in the previous calculation. The aggregate was converted into sterling at the current rate of exchange instead of the estimated rate at the close-down date. The proportion of the total cost of abandonment attributable to the taxpayer company's 25 per cent. share was £2.273 million. The provision made in the 1976 accounts was then deducted, leaving a net balance of £1.204 million. A fresh appraisal was made by the operator of the estimated production from the Argyll field for 1977 and subsequent years, and the proportion attributable to 1977—approximately six-tenths—was applied to the balance of the total cost of £1.204 million. That yielded a provision of £734,000.

This method of calculating the provision to be made in each year's accounts (which has been described as a "unit of production method") has the advantage that a fresh estimate has to be made each year of the cost of abandonment and of the expected life and future yield of the field. As the years pass these calculations will inevitably become increasingly reliable. For instance, over the years assumptions as to inflationary increases in cost can be corrected in the light of current prices and labour costs. Thus as the years go by the total provision made over the years will approximate more and more nearly to the actual cost when incurred and of course in time the assumption as to the close-down date will cease to be an assumption. For this reason this method of calculating the annual provision was referred to by the experts who gave evidence before commissioners as self-correcting. It is nonetheless important to bear in mind that no method of making an annual provision in advance of expenditure of this kind can be wholly self-correcting. There are two reasons. (I leave aside the obvious point that however carefully the cost of abandonment is calculated the actual cost may be more or less than the estimate on which the calculation of the most recent provision was based.) First, if in a given year the cost is revised upwards, or if additional items such as the reconversion of the tankers and the insurance are added, the provision in earlier years will be inadequate and will be compensated by over-provision in subsequent years; conversely, if the cost is revised downwards the provision in earlier years will be an over-provision and will be compensated by an under-provision in subsequent years. Similarly, if the estimate of future production is revised upwards the provision in earlier years will be an over-provision, the provision being based on an allocation of cost to each barrel of oil produced and expected to be produced. If the estimate is revised downwards, because, for instance, a geological fault is discovered which makes part of the reserves of oil irrecoverable, the provision in earlier years will be an under-provision. However, it is common ground that this method of making an annual provision to meet an uncertain cost which will be incurred at an uncertain future date by relating it to an uncertain total production figure is the best that can be devised. It would not be practicable, even if it were permissible, to reopen the accounts on the abandonment of the oilfield and to make an exact calculation of the abandonment costs for each unit of production in the light of known cost and known total production.

The issues

Before the commissioners the Crown advanced four submissions. They were, first, that the expenditure when incurred will not be incurred wholly and exclusively for the purposes of the taxpayer company's trade within section 130(*a*) of the Income and Corporation Taxes Act 1970; secondly, that the expenditure will be of the nature of capital expenditure and that the provision is accordingly precluded by section 130(*f*); thirdly, that the provision is impermissible because it anticipates losses in future years and is not directly related to profits earned in each year and, fourthly, that even if in principle a provision to meet a future liability can be allowed the expenditure for which provision is made in the present case and the basis on which that provision is calculated, resting as it does on assumptions as to the life and yield of the oilfield, are too uncertain and speculative for the provision to be a proper deduction for tax purposes. On the view I take of this case the second of these

submissions is of central importance and is determinative. However, before turning to examine it I should say something about the accounting evidence adduced before the commissioners.

Accountancy evidence

Lord Reid observed in *B.S.C. Footwear Ltd. v. Ridgway* [1972] A.C. 544, 552, that in ascertaining the taxable profit of a trade

> "it is well settled that the ordinary principles of commercial accounting must be used except in so far as any specific statutory provision requires otherwise."

In *Southern Railway of Peru Ltd. v. Owen* [1957] A.C. 334, 360, Lord Radcliffe said that he would

> "view with dismay the assertion of legal theories as to the ascertainment of true annual profits which were in conflict with current accountancy practice and were not required by some special statutory provision of the Income Tax Acts."

In *Odeon Associated Theatres Ltd. v. Jones* [1971] 1 W.L.R. 442, Sir John Pennycuick V.-C. explained what is meant by the phrase "ordinary principles of commercial accountancy" in a passage which I think I should read in full. He said, at p. 454:

> "I think that in deference to the arguments of Mr. Watson and also of Mr. Medd and to the authorities which were cited I ought to say a few words by way of explanation of the time-honoured expression 'ordinary principles of commercial accountancy.' The concern of the court in this connection is to ascertain the true profit of the taxpayer. That and nothing else, apart from express statutory adjustments, is the subject of taxation in respect of a trade. In so ascertaining the true profit of a trade the court applies the correct principles of the prevailing system of commercial accountancy. I use the word 'correct' deliberately. In order to ascertain what are the correct principles it has recourse to the evidence of accountants. That evidence is conclusive on the practice of accountants in the sense of the principles on which accountants act in practice. That is a question of pure fact, but the court itself has to make a final decision as to whether that practice corresponds to the correct principles of commercial accountancy. No doubt in the vast proportion of cases the court will agree with the accountants but it will not necessarily do so. Again there may be a divergency of view between the accountants, or there may be alternative principles, none of which can be said to be incorrect, or, of course, there may be no accountancy evidence at all. The cases illustrate these various points. At the end of the day the court must determine what is the correct principle of commercial accountancy to be applied. Having done so, it will ascertain the true profit of the trade according to that principle, and the profit so ascertained is the subject of taxation. The expression 'ordinary principles of commercial accountancy' is, as I understand it, employed to denote what is involved in this composite process. Properly understood it presents no difficulty, and I would not be at all disposed to attempt any alternative label."

The judgment of the Vice-Chancellor was affirmed in the Court of Appeal [1973] Ch. 288. Salmon L.J. stated the principle succinctly when he said, at p. 294:

> "In my judgment, the true proposition of law is well established, namely that, in determining what is capital expenditure and what is revenue expenditure in order to arrive at the profit for tax purposes in any particular year, the courts will follow the established principles of sound commercial accounting unless they conflict with the law as laid down in any statute."

In the instant case evidence was given by Mr. Young F.C.A., a partner in the well-known firm of accountants who were joint auditors of the Rio Tinto Zinc group, by a Mr. Stacy F.C.A., a partner in another well-known firm of accountants and a member of the Auditing Practices Committee of the United Kingdom Consultancy Committee of Accountancy Bodies, and by a Mr. Lawson F.C.A., then the director of the Professional Advisory Accountants to the Board of Inland Revenue. All three were agreed that it was proper and prudent to make provision in the accounts for the estimated costs of abandonment and that the method of making provision adopted in the accounts of the taxpayer company was both the recognised method and the most accurate that could be devised. The commissioners accepted that the method of apportioning the cost of abandonment that had been adopted was that commonly adopted in this and similar trading operations, and found first that it was apt to spread "the estimated cost over the current and remaining years of production," and secondly that it had the result that the expenditure was "related to profits earned in the relevant year." On that ground they rejected the Crown's third submission. They also found as a fact that "on the basis of the evidence of Mr. Young, Mr. Stacy, and the revenue's own expert witness, Mr. Lawson, the accounts of [the taxpayer company] for 1976 and 1977 were correctly drawn up in accordance with the ordinary principles of commercial accountancy."

As to the Crown's fourth submission the commissioners observed:

> "Different individuals will inevitably make different assumptions, and so arrive at different conclusions, when forecasting, but provided that a bona fide attempt is made to achieve as accurate a figure as possible, and care is exercised in considering the elements involved in the calculations, that, it seems to us, is acceptable."

They then found:

> "the estimates were made with due care in the light of the information available at the time, and that the inclusion of provisions based on these estimates is not invalidated by subsequent events."

On that ground they rejected the Crown's fourth submission.

The reasoning of the commissioners on these two points has been attacked by Mr. Park. I shall return to his criticisms briefly at the end of this judgment. It is important to bear in mind that the accountancy evidence and the commissioners' conclusions on it do not bear upon the second question—whether the expenditure when incurred will be expenditure on revenue or capital account, and if the latter whether an advance provision to meet that expenditure related to the production of oil year by year is a permissible deduction for tax purposes. The commissioners have found that in ascertaining the commercial profit

derived from the exploitation of the Argyll oilfield in accordance with correct principles of accountancy such a provision must be made. That conclusion is in fact inevitable in view of the magnitude of the sums involved and the nature of the expenditure, and in the light of the accountancy evidence. However, the same provision will have to be made whether the expenditure when incurred will be expenditure on revenue or capital account. To the extent that the expenditure when incurred will be capital expenditure the annual provision is analogous to a provision for depreciation of capital expenditure. It is elementary that, although it may be necessary in order to give a true and fair view of the profits earned by a trade in a given year to make an allowance for the depreciation of a wasting asset on which capital has been expended, no such allowance can be made in ascertaining the taxable profits for that year. The disallowance has always been founded in cases within Case I of Schedule D on that part of rule 3 of the rules applicable to that Case which is now reproduced (though modified so far as concerns the deduction of interest on capital) in section 130(*f*): see, in particular, *Alianza Co. Ltd. v. Bell* [1906] A.C. 18.

Capital or revenue expenditure

I turn therefore to what in my judgment is the only issue in this case—that is, whether the expenditure in question when incurred will be expenditure on capital or revenue account. I have been referred to a very large number of authorities. I propose to refer only to very few of them. In *Sun Newspapers Ltd. v. Federal Commissioner of Taxation* (1938) 61 C.L.R. 337, Dixon J. explained the distinction between expenditure on revenue and expenditure on capital account in a passage which has often been cited but which I will cite again. He said, at p. 359:

> "The distinction between expenditure and outgoings on revenue account and on capital account corresponds with the distinction between the business entity, structure, or organisation set up or established for the earning of profit and the process by which such an organisation operates to obtain regular returns by means of regular outlay, the difference between the outlay and returns representing profit or loss. The business structure or entity or organisation may assume any of an almost infinite variety of shapes and it may be difficult to comprehend under one description all the forms in which it may be manifested. In a trade or pursuit where little or no plant is required, it may be represented by no more than the intangible elements constituting what is commonly called goodwill, that is, widespread or general reputation, habitual patronage by clients or customers and an organised method of serving their needs. At the other extreme it may consist in a great aggregate of buildings, machinery and plant all assembled and systematised as the material means by which an organised body of men produce and distribute commodities or perform services. But in spite of the entirely different forms, material and immaterial, in which it may be expressed, such sources of income contain or consist in what has been called a 'profit-yielding subject,' the phrase of Lord Blackburn in *United Collieries Ltd. v. Inland Revenue Commissioners,* 1930 S.C. 215, 220."

Then, having referred to a number of cases in which this distinction has been drawn he added, at p. 363:

> "There are, I think, three matters to be considered, (*a*) the character of the advantage sought, and in this its lasting qualities may play a part, (*b*) the manner in which it is to be used, relied upon or enjoyed, and in this and under the former head recurrence may play its part, and (*c*) the means adopted to obtain it; that is, by providing a periodical reward or outlay to cover its use or enjoyment for periods commensurate with the payment or by making a final provision or payment so as to secure future use or enjoyment."

In *Hallstroms Pty. Ltd. v. Federal Commissioner of Taxation* (1947) 72 C.L.R. 634, having referred to his judgment in the *Sun Newspapers* case Dixon J. added, at p. 646:

> "My own opinions upon the question I have attempted to explain in *Sun Newspapers Ltd. v. Federal Commissioner of Taxation* and I shall not restate them. I shall treat the passage to which I refer as incorporated in this judgment. Once more, however, I shall endeavour to apply what I conceive to be the principles that determine whether an outgoing is on account of capital or of revenue. As a prefatory remark it may be useful to recall the general consideration that the contrast between the two forms of expenditure corresponds to the distinction between the acquisition of the means of production and the use of them; between establishing or extending a business organization and carrying on the business; between the implements employed in work and the regular performance of the work in which they are employed; between an enterprise itself and the sustained effort of those engaged in it."

If that test is applied to the expenditure for which provision has been made in the instant case then, with one exception, in my judgment there cannot be any doubt on which side of the line it falls. I will take first the rig. The rig is quite plainly part of the profit-earning apparatus; the means which had to be provided for the extraction of oil. If the rig had been purchased or if the taxpayer company had paid a sum to acquire the benefit of a contract of hire the consideration would clearly have been capital expenditure. That I think was accepted by Mr. Gardiner. What is said is that by entering into the contract of hire the taxpayer company did not acquire a capital asset and that what falls to be paid under the contract of hire, whether by way of hire charges or for maintenance or for the restoration of the rig to drilling condition on termination of the hire, is revenue expenditure, expenditure incurred in the ordinary course of the taxpayer company's trading operations. I do not think that that is a valid distinction. The contract of hire is clearly a capital asset just as a lease of land on which a trader conducts his business is a capital asset. If the benefit of the contract of hire had been sold the consideration would have been a capital and not a revenue profit. It can make no difference that being non-assignable the contract of hire has no balance sheet value: see *per* Lord Wilberforce in *Tucker v. Granada Motorway Services Ltd.* [1979] 1 W.L.R. 683, 686. If the contract of hire is a capital asset once for all expenditure on the rig to adapt it for the purposes of the trade was and expenditure to reconvert to drilling condition if required will be capital expenditure.

The tankers are in no different position. The cost alike of laying a pipeline or purchasing and adapting a tanker to transport the oil ashore would have been expenditure on the acquisition of a capital asset. So the charterparties are equally capital assets and the cost of adapting the tankers for use in the trade was and the cost of reconverting them, if it becomes necessary, will be capital expenditure. Mr. Gardiner submitted that in the case of the tankers the expenditure is actually or potentially recurrent and that they were converted and in due course may fall to be reconverted while the trade is still continuing as part of the regular flow of expenditure in winning the oil and bringing it ashore. He instanced as an analogy the case of a trader who needs a fleet of vans and who hires suitable vans temporarily surplus to the requirements of another trader carrying on a similar trade and then adapts them by painting out the name of the trader from whom the vans are hired and substituting his own. The dangers in this context of reasoning by analogy have often been emphasised: see in particular the observations of Oliver L.J. in *Whitehead v. Tubbs (Elastics) Ltd.* (1984) 57 T.C. 472, 492. I do not find it necessary to consider whether in the example given the expenditure would be expenditure on capital or revenue account. Lord Upjohn observed in *Strick v. Regent Oil Co. Ltd.* [1966] A.C. 295, 345, that the distinction is one of "fact and degree and above all judicial common sense in all the circumstances of the case." Sir Robert Megarry V.-C. commented in *Pitt v. Castle Hill Warehousing Co. Ltd.* [1974] 1 W.L.R. 1624, 1629:

> "In other judgments there are references to 'common sense' simpliciter, but the adjective 'judicial' may be useful as indicating that the kind of common sense needed is one that is not at large, but is guided and tutored by the authorities."

On the facts of this case the tankers were hired with the expectation that they would be employed in the business of winning oil from the North Sea for a substantial period and the expenditure on them to adapt them for the use to which they were to be put was to my mind clearly designed to make them "more advantageous as income-winning assets:" see *Pyrah v. Annis & Co. Ltd.* [1957] 1 W.L.R. 190, 195. The cost of reconverting them in compliance with the provisions of the charterparties can be in no different category.

Turning to the clutter, the manifold, the loading lines and buoy are again part of the apparatus that had to be installed before the operation of winning the oil and transporting it ashore could begin. This part of the clutter was installed under the authority of the licence and the conditions imposed by that licence require, not expressly but as a matter of practical certainty, that it will have to be removed when the exploitation of the field is completed. The cost of removing this part of the clutter is thus part of the cost that had to be incurred or which the consortium had to agree to incur in the future before it could commence its trading operations. It makes no difference in this connection whether the obligation to remove the clutter is seen as imposed by the licence or by the legislation in pursuance of which the licence was granted. Mr. Gardiner drew an analogy between a permission given by a local or highway authority to a builder to erect scaffolding obstructing a public right of way for the purpose of carrying out repairs which the builder had undertaken as part of his trade and which is given on condition that the scaffolding will in due course be removed. The analogy seems to me

too far-fetched to warrant examination. Prima facie the erection of the scaffolding would be part of the recurrent operations of undertaking repairs.

I turn therefore to the remainder of the clutter—the boreholes and well heads and the flow lines. Mr. Gardiner submitted that even if the manifold and the loading lines and buoy are to be treated as part of the profit-earning apparatus the operations of boring the wells and installing the well heads and of connecting the well heads to the manifold are ordinary recurrent trading operations undertaken in the course of winning the oil which the consortium had been licensed to exploit. He compared the production platform, the manifold and loading lines and buoy to the main shaft sunk in a coalfield and the boreholes, well heads and flow lines to adits struck from the main shaft to obtain access to seams of coal. The boreholes, he submitted, were no more than perforations made to penetrate a reservoir of oil which the consortium had the right to exploit. Once perforated the oil flows by natural pressures to the apparatus installed to enable it to be processed and transported.

No attempt was made before the commissioners to distinguish between the parts of the clutter before and the parts after the manifold, and in my judgment it is not fairly open to the taxpayer company to seek to draw this distinction in this appeal. There are statements of high authority that the question whether expenditure is income or capital is a question of fact to be determined by the commissioners, or when there is no express finding by the commissioners by this court on the material available to it: see *British Insulated and Helsby Cables Ltd. v. Atherton* [1926] A.C. 205, *per* Viscount Cave L.-C., at p. 213. I have already cited the observation by Lord Upjohn in *Strick v. Regent Oil Co. Ltd.* [1966] A.C. 295, 345 that the question is one of fact and degree and of judicial common sense. There are equally statements of high authority that the question is ultimately one of law. I do not think that there is any inconsistency between these apparently conflicting statements. They are directed to different aspects or stages of a composite process. It is for the commissioners to determine the nature and purpose of expenditure—whether for instance expenditure, albeit exceptional or even once-for-all expenditure, on property acquired by the taxpayer was expenditure for remedying an accrued want of repair or expenditure on improvements or incurred with a view to making the property commercially viable for the purpose for which it was acquired. Whether expenditure so categorised should be debited to income or capital account is a question to be determined in the light of evidence as to what is currently accepted as proper accountancy practice. And what is currently accepted as proper accountancy practice is, of course, a question of fact to be determined by the commissioners. But whether current accountancy practice accords with the principles developed by the courts—that is, whether it is correct accountancy practice—must be ultimately a question of law, and a finding by the commissioners as to what is correct accountancy practice is capable of being reviewed by this court. Lastly, a provision which in accordance with correct accountancy practice ought to be debited to revenue account in order to give a true and fair view of the profits of a trade may nonetheless fall to be disallowed in ascertaining those profits of the trade for tax purposes because the deduction would infringe some specific statutory provision.

In the instant case the burden was on the taxpayer company to discharge the assessment and it was for the taxpayer company to establish any special features which might categorise the boring of the boreholes and the installation of well heads and flow lines as recurrent revenue expenditure and serve to differentiate it from the rest of the clutter. However, I do not think it would be right to leave the matter there. There is the high authority of Viscount Cave L.-C. in the *Atherton* case for the proposition that in the absence of any specific finding by the commissioners it is for the court to determine whether expenditure is on income or capital account on the materials available to it. I cannot see that any distinction can fairly be drawn between the boreholes, well heads and flow lines on the one hand and the rig, the manifold and the loading lines and buoy on the other hand. All are part of a comprehensive installation designed to obtain access to and to win and transport oil from the oilfield to onshore facilities. Of course the boreholes, unlike the rig, the manifold and the loading lines and buoy, were not all bored at once. Boreholes were made as and when knowledge and experience of the geological formation and other factors governing the accessibility and flow of the oil were acquired. However, the drilling of the boreholes and the installation of the necessary well heads and flow lines seems to me part of a continuing programme of capital expenditure. Of 15 boreholes which had been drilled when the commissioners gave their decision five were dry and of the remaining ten, four had been capped and six were still in production. The capping of all those ten boreholes and the removal of the well heads and flow lines is work which the consortium has had to carry out or will be required to carry out to comply with the conditions of the licence, and in my judgment is capital expenditure.

The commissioners in reaching their conclusion on this issue were much influenced by the decision of the Court of Session in *Robert Addie and Sons' Collieries Ltd. v. Inland Revenue Commissioners*, 1924 S.C. 231; 8 T.C. 671. In that case the taxpayer company was required under a mining lease to reinstate land occupied by it or damaged by its underground workings, or at its option to pay a sum equal to 30 years' purchase of the annual value of the land for agricultural purposes. The company exercised that option. It was held by the Court of Session that the sum which the company became liable to pay was expenditure on capital account. Lord Clyde, the Lord President, based that conclusion on two grounds. The first was that the moneys were not laid out wholly and exclusively for the purposes of the trade within what is now section 130(*a*). The second is contained in a passage which I should I think read in full. He said, 8 T.C. 671, 677:

> "The whole terms of the lease are not before the court, but, as far as they have been put before us in the case, it is clear that it was within the contractual contemplation of parties that the lessees working under the lease and in accordance with its provisions would, or might, cause damage to land by subsidence of a character so serious and permanent as to destroy its value unless restored in some way. A right to work the coal in such a manner as to sacrifice the value of the surface was a material asset for the company to possess, and, not unnaturally or unusually, the same principle was applied in the lease to the conferment of that right on the company as in the case of surface occupation by debris heaps and the like.

A The price of acquiring that right is a capital outlay. No distinction can, in my opinion, be drawn between the payment or consideration paid for permanent injury done by subsidence as the result of operations under the lease and permanent injury done by the depositing of debris as the result of those operations. Neither the expense of restoration, nor the compensation payable failing restoration, appear to me to fall within working expenses. They are, B in my opinion, capital charges."

I agree with the commissioners that the principle stated in that paragraph is equally applicable to the instant case. Part of the consideration given for the right to win oil from Argyll field was the acceptance of an obligation which in practice was an obligation to remove the clutter when the oilfield was exhausted, or, in the case of wells previously C abandoned, to cap and remove the well heads and flow lines before the field was exhausted.

The other issues

Mr. Park accepted and I think was right to accept that given that the obligation to remove the clutter was imposed by the licence and that D acceptance of it was in substance part of the consideration given by the consortium for the right to win oil from the North Sea the expenditure when incurred will be expenditure wholly and exclusively incurred for the purposes of the taxpayer company's trade even if on the abandonment of the Argyll field the taxpayer company's trade comes to an end. He submitted that in the absence of an obligation incurred or imposed as a E condition of the right to commence the exploitation of oil in the North Sea, expenditure on abandonment of the field for reasons of commercial expediency would not be expenditure incurred for the purposes of but for the purposes of withdrawing from the trade. As to the third and fourth submissions relied on before the commissioners he submitted that if the estimate of future expenditure could be considered to be an estimate of future revenue expenditure the annual provision would be F impermissible because it does not meet the second of the two requirements specified by Lord Radcliffe in *Southern Railway of Peru Ltd. v. Owen* [1957] A.C. 334, 357, namely, that even if established accountancy practice requires that some deduction be made to meet a future obligation it must be possible to give an affirmative answer to the question: "Do the circumstances of the case, which include the techniques G of established accounting practice, make it possible to supply a figure reliable enough for the purpose?" He criticised the decision of the commissioners on the ground that in order to give an affirmative answer to this question it is not enough to find that (in their words) "the estimates were made with due care in the light of the information available at the time . . ."

These questions were fully argued before the commissioners and H were fully argued before me. If they had been questions capable of being answered on the facts found by the commissioners I would have thought it right, in view of this full argument, to express my opinion on them. But they are questions which cannot arise on the facts found by the commissioners. It cannot sensibly be asked whether a provision to meet estimated future expenditure which when incurred will be capital expenditure would, if that estimate had been an estimate of future revenue expenditure, have been a permissible deduction in ascertaining

profits for tax purposes. The features of the expenditure which led to its being characterised as revenue expenditure might be very material in determining whether an annual provision could properly be made—for instance, whether the expenditure was recurrent and capable of reasonably accurate actuarial estimation: see *Sun Insurance Office v. Clark* [1912] A.C. 443, 451, *per* Earl Loreburn L.-C.

Conclusion

In my judgment therefore the taxpayer company has not established that there is any ground on which the court can interfere with the finding by the commissioners that the provision in question was made to meet future expenditure on capital account and that a deduction is accordingly precluded by section 130(*f*) of the Act of 1970. Indeed, I do not think that the commissioners applying the proper test could have reached any other conclusion. Mr. Gardiner submitted that if no such provision can be made then given the magnitude of the expenditure—which might, he said, amount to some £600 billion over the North Sea oilfield as a whole—and given present and likely future rates of tax the exploitation of North Sea oil might be rendered uneconomic. However, that observation would be equally applicable to the refusal of an allowance for depreciation in the case of any speculative and short-lived venture requiring substantial capital expenditure. The legislature has not left the allowance of depreciation to be determined in accordance with accountancy principles and practice. Instead, it has imposed a general prohibition and has then, since 1886, dealt with the question whether a depreciation allowance should be made in a particular case by a separate, detailed and frequently amended code. The question whether that code should now be further amended to permit the deduction claimed in the instant case is one which must be determined by the legislature and not by the courts.

Appeal dismissed with costs.
Cases remitted to commissioners for figures to be adjusted.

Solicitors: Clifford Chance; Solicitor of Inland Revenue.

[Reported by MRS. HARRIET DUTTON, Barrister-at-Law]