[HIGH COURT OF AUSTRALIA.]

EASTAWAY AND OTHERS . . . . . APPELLANTS ;
PLAINTIFFS,

AND

THE COMMONWEALTH . . . . . RESPONDENT.
DEFENDANT,

H. C. OF A. 1950-1951.

1950, SYDNEY, *Sept.* 5-8.

ADELAIDE, *Oct.* 2.

SYDNEY, *Dec.* 20.

Webb J.

1951, SYDNEY, *July* 11, 12.

MELBOURNE, *Oct.* 8.

Dixon, Williams and Kitto JJ.

Resumption of Land—Acquisition by Commonwealth—Compensation—Assessment—Business conducted on land—Closed down by reason of acquisition—Goodwill—Going-concern—Capitalization of profits—Lands Acquisition Act 1906-1936 (*No.* 13 *of* 1906—*No.* 60 *of* 1936), *s.* 29 (1) (*a*).

In assessing the value of land acquired by compulsory process where the loss of the land has necessarily resulted in the closing down of the business which the owner was carrying on upon the land, one method is to take into account the value of the goodwill of the business so closed down and assess compensation at an amount equal to the value of the whole undertaking regarded as a going concern.

In deciding what would be a reasonable rate of capitalization as a basis for such a valuation it is material to take into account the nature of the tangible assets in which the capital is invested.

APPEAL from *Webb* J.

An action was commenced on 12th August 1949, in the High Court by William Bloor Eastaway, Norman Henry Davies Eastaway and W. B. Eastaway & Co. Pty. Ltd. against the Commonwealth of Australia for compensation in respect of certain land acquired by the Commonwealth containing two roods, twenty-three and one-half perches situate at the corner of Unwins Bridge Road and Garden Street, St. Peters, Sydney, and being the land comprised in certificate of title, vol. 209, folio 235, and certificate of title, vol. 284, folio 198 ; the buildings erected thereon, and the machinery, plant and goodwill of the plaintiffs' business, which was alleged to have been destroyed.

The two first-named plaintiffs were the registered proprietors of an estate in fee simple as joint tenants of the land which they held in trust for the company, the third-named plaintiff.

The company had for many years carried on business on the land as engineers and ironfounders, and had on the land a large quantity of machinery, plant and trading stock. The plaintiffs claimed that the business was a valuable one and, with the cessation of hostilities, it was certain to expand, and, further, that in 1947 it had attached to it a very valuable goodwill and, in April 1947, it had much work in progress.

In the Commonwealth of Australia *Gazette* of 17th April 1947 there was published a notification dated 9th June 1943 that the land, together with all tanks and buildings, if any, thereon, had been acquired by the Commonwealth under the *Lands Acquisition Act* 1906-1936, for the purposes of the Commonwealth.

The plaintiffs stated that they had been unable to find any other land to which the business could be transferred, and that the business and the goodwill thereof had been wholly lost to the company which had suffered other serious loss as regards machinery, plant, trading stock and work in progress.

The plaintiffs claimed: the value of the land and buildings thereon, £8,150; the value of machinery, plant &c., net £21,735 5s. 9d.; the value of the goodwill of the business destroyed, £17,500; the value of trading stock and works in progress, £4,024 3s. 6d.; *less* the value of the trading stock and works in progress, taken over by the Commonwealth, £4,024 3s. 6d.; and the sum of £30,000 received from the Commonwealth.

The plaintiff company was originally known as Rivoli Entertainments Ltd., but on 30th June 1943, the name was in process of being changed to W. B. Eastaway & Co. Pty. Ltd. An agreement in writing made on that date between Rivoli Entertainments Ltd. and the two first-named plaintiffs and their father, Edward Samuel Lewis Eastaway, recited that the two first-named plaintiffs had for some time past carried on the business of engineers at Unwins Bridge Road, St. Peters, and that Norman Henry Davies Eastaway and Edward Samuel Lewis Eastaway had carried on the business of ironfounders at the same address; and that the company proposed to acquire and carry on those businesses. By the agreement it was agreed: that the three Eastaways should sell and the company should purchase, for the sum of £19,344 10s. 0d., all the plant, machinery, engines, patterns, drawings, designs, apparatus tools and the like chattels belonging to the vendors and used in or adopted or intended for those businesses; for the sum of

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£4,215 4s. 0d., all the finished goods, stock-in-trade, general stores and stock of materials and things in or about the premises or belonging to the businesses, and also for the works in progress on the premises; for the sum of £3,607 3s. 7d. the book debts of the vendors; and for the sum of £5,548 12s. 7d. the goodwill of the businesses. The company agreed to take over the sundry creditors owing by the vendors at the sum of £2,284 9s. 10d. The agreement provided that the purchase should take effect from 30th June 1943, and that on the following day, upon satisfaction of the purchase money, possession should be given to the company, which should thereupon carry on the businesses so as to maintain them as a going concern. Although the agreement further provided that the company would accept a weekly tenancy of the premises upon which the business was carried on at a rental to be agreed upon between the parties, such a tenancy was never entered into, nor was it required because, by a declaration of trust made on 30th June 1943, the two first-named plaintiffs declared that they held the land and premises upon trust for the company and they appointed the company their attorney to complete the transfer of the land and premises to the company. Such transfer was never made.

The plaintiff William Bloor Eastaway was appointed managing director and chairman of directors of the company and the plaintiff Norman Henry Davies Eastaway was appointed director. Each of those plaintiffs held 15,000 of the 35,000 shares issued by the company, the remaining 5,000 shares being held by other persons.

The summarized trading and profit and loss accounts showed, *inter alia*, the following :—

	Years ended 30th June					
	1942	1943	1944	1945	1946	1947
Sales	30,422	29,413	26,493	24,164	24,561	23,544
Stock on hand and work in progress at end of year	400	400	400	400	400	1,900
Purchases	12,607	11,433	6,715	7,621	6,748	6,521
Gross profit	11,682	6,573	8,844	6,983	8,104	8,731
Salaries (directors)	—	—	2,719	2,132	2,132	2,132
Salaries (office)	508	—	577	466	449	369
Net profit	9,749	4,752	2,503	1,589	2,527	3,520
An adjustment to those net profits made on behalf of the company showed :— *Add* directors' salaries— W. B. Eastaway £1,040 W. H. D. Eastaway 780	—	—	1,820	1,820	1,820	1,820
Add preliminary expenses re company £1,000.	—	—	343	343	343	—
Adjusted net profits before charging income tax	9,749	4,752	4,166	3,752	4,690	5,340

The action was heard by *Webb* J., in whose judgment and in the judgment of the appellate court, further facts appear.

C. M. Collins and *L. C. Gruzman* for the plaintiffs.

E. J. Hooke, for the defendant.

Cur. adv. vult.

Oct. 2; Dec. 20.

The following written judgment was delivered :—

WEBB J. This is an action for compensation for land at St. Peters, Sydney, New South Wales, resumed by the defendant Commonwealth under the *Lands Acquisition Act* 1906-1936. The defendant has already paid £30,000 to the plaintiffs, who, however, claim a further £19,180 5s. 9d.

The resumption notice was dated 9th June 1943, but was not gazetted until 17th April 1947. The compensation is then to be assessed as at 1st January 1947. Nothing turns on the delay in gazetting the notice. The plaintiffs became aware of the notice shortly after it was signed and suggested that the threat of resumption retarded, if it did not prevent, expansion of the business ; but they did not claim compensation on the basis of potentially greater profits from expansion.

The resumed land was held by the two individual plaintiffs on trust for the third plaintiff, a company which conducted on the land the business of engineers and ironfounders. The claim is in respect of land and buildings, machinery and plant, and goodwill. It was common ground that compensation was payable in respect of all three items, and that compensation for the land and buildings might be separately assessed. It was not suggested by the defendant that the plaintiff company could have retained the goodwill by continuing the business on another site.

As to the land and buildings no question arises : it was conceded by the defendant that their value could be taken to be £8,150, being £3,150 for the land and £5,000 for the improvements. As the statement of claim set out the value of the land and improvements as £8,000, leave was given to amend it by substituting £8,150 for £8,000.

As to the machinery and plant and goodwill : I have decided to take into account the profits made in the business during the five years ended the 30th June 1947. The claim was made on that basis, although the plaintiff company did not take over the business until 30th June 1943. The company then purchased from a partnership consisting of the two individual plaintiffs and

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appears to have continued the business on the same lines as the partnership. The defendant did not object to the assessment of compensation on the basis of the average profits for five years: the contest was as to what were the profits, and at what rate of interest they should be capitalized. The plaintiffs first arrived at the profits after deducting, among other expenditure, all salaries, but then adjusted the result by adding to the profits the salaries of the managing director and directors, that is, of the two individual plaintiffs and their brother, who throughout worked full time in the business. Although persons fixing their own remuneration might be disposed to over-value their services I can make no allowance for that here, as there was no evidence justifying the conclusion that these salaries were not fully earned in each case. For this reason no part of the directors' salaries can properly be included in the profits.

The profits were arrived at from income tax returns of the partnership and the balance sheets and profit and loss accounts. As directors' and office salaries, expenditure on motor transport, telephones and postages were not allowed for in the figures supplied by the plaintiffs for the year ended 30th June 1943, I made an estimate of these items, having regard to similar payments in other years. Other items in the returns, balance sheets and profit and loss accounts, except the two items "stock-in-trade and work in progress" and "good-will" were not challenged by the defendant. The first of these items was shown as £400 on 30th June 1943, but the agreement between the plaintiff company and the partnership reveals that it should have been £4,215 on that date. "Good-will" is shown in the balance sheets as being £11,646.

After deducting six shillings in the pound for income tax, which apparently the parties were satisfied should be done as a witness on each side based his calculations on such a deduction, I find the average profits for the five years to have been about £1,500, taking five per cent as the rental value of the land—about which there was no real dispute—but without taking into account the value of the stock in trade and the work in progress on 1st July 1943 (£4,215) and 30th June 1947 (£1,900). However, the decline in value of stock-in-hand and work in progress during the five years must, I think, be taken into account in ascertaining the profits, and it reduces the average profit to less than £1,050. The defendant's witness, Wheeler, really left it out of account, as he took only the three years 1944 to 1946, inclusive, and accepted £400 as the value of stock-in-trade and work in progress at the beginning and end of each of the three years. But this was arbitrary. In

any event the high rate of capitalization which he adopted ensured that the total compensation as calculated by him would be greatly below £30,000.

Then as to the rate of interest to be taken for capitalization: the plaintiffs submitted that five per cent was proper. The defendant's witness, Wheeler, suggested ten per cent but took eight per cent in his calculation. I have come to the conclusion that six per cent is a reasonable rate for a business of this kind and size, which in Sydney should be more or less stable. At six per cent the capitalized average profit of £1,050 amounts to £17,150.

Then, taking £17,150 as the value of the machinery and plant and goodwill, and adding £8,150 for the land and buildings, I find the compensation to be £25,300. As the defendant has already paid £30,000 to the plaintiff nothing further is payable.

I give judgment for the defendant.

From that decision the plaintiffs appealed to the Full Court of the High Court.

G. E. Barwick K.C. (with him *L. C. Gruzman*), for the appellants. The business was not one which after the resumption was susceptible to removal in any economic sense. There was not any other available site. It was not shown that the sum of £4,215 was the value of stock in actual existence at 30th June 1943. That figure should not have been substituted by the trial judge for the sum of £400 shown by the appellants. In arriving at the net profits of the business the salaries paid to the directors should not be deducted but should be written back. The capacity of the business should be approached with the circumstance in mind that it provided to the working proprietors those salaries, some part of which was much more likely than not to be in excess of the amount for which the company could obtain similar services from a stranger. The mere fact that those amounts were not shown in the income tax return had no bearing on the matter. Because of the resumption the appellants were unable to accept profitable orders, and also lost trained personnel who preferred permanent positions. The rate of capitalization should reflect the circumstance that the net profits in the various years were not truly representative. The evidence shows the appellant company to have an old-established business, secure, owning the land, with physical room for expansion up to quite a large area, 15,000 square feet, and financially equipped to expand. There was machinery available for expansion. The company had continuity of available work for years ahead, and it

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was operating profitably under the restricted conditions in the relevant years. During those years the company had difficulties of retaining staff and there existed restricted conditions which necessitated the employment of perhaps outmoded gear. Nevertheless the company paid profits as shown and also salaries to the two proprietor directors. Contrary to the finding of the trial judge, such a business certainly had a goodwill, and the assets were not worth less than their market value. The adjustments made by the trial judge in respect of the 1943 figures are challenged by the appellants. A deduction for tax should not have been made: the tax should not have been taken into consideration. There was nothing to warrant the trial judge comparing the figure as the stock-in-hand in the vendors' agreement with the final physical count in 1947, and concluding that the difference had been lost.

A. R. Taylor K.C. (with him *E. J. Hooke* and *R. W. Hooke*), for the respondent. At first the plaintiffs' case was presented on the basis of the capital value of the business, that being the value of the land to them, and they wanted the business valued by having regard to the profits and then capitalizing the profits, but it was finally presented, wholly and solely, on the basis of the total destruction of the business, and reasonable offers made by the respondent were rejected by the appellants. It does not necessarily follow that a company which has an established business and which is making profits, must have a valuable goodwill. Although it is not disputed that the profits being made in the business may be a vital matter for consideration when determining whether the company has goodwill, an equally vital matter is the amount of capital sunk in the company. The salaries paid to the two appellant directors should not have been written back. As the trial judge found, there was not any evidence to justify the conclusion that those salaries were not fully earned, and for that reason no part of those salaries could properly be included in the profits. The directors in this case were in a position somewhat different from the position of the directors in *McCathie* v. *Federal Commissioner of Taxation* (1). The result of writing back the directors' salaries, and the way in which the appellants' expert did it, really operated to give to the two directors the present value of £1,820 between them for ever, and that is really the difference between the parties, the capital value of the business, £33,000. Capitalization should be at a higher rate than five per cent. All the experts agreed that 1942 was an unusual year which

(1) (1944) 69 C.L.R. 1, at p. 12.

presented some peculiar features, and that it should be excluded from consideration. Apparently it is conceded that the figures shown each year for stock-in-hand and works in progress were completely artificial and incomplete figures. The Court, therefore, has the choice of accepting those figures or the figure of £4,215 4s. 0d. shown in the vendors' and purchaser's agreement dated 30th June 1943, and certified by the company's auditor as being correct. In the circumstances, income tax, or company tax, at the rate of six shillings in the pound, was properly deducted in order to ascertain what return there would be on money invested in the company. The deduction was made on the invitation of counsel for both parties. Although the appellants claim that the business was destroyed, assets to the value of £11,681 were either retained by, or the value thereof was paid to, the company. That sum deducted from the sum of £33,000, being the value of the business apart from the land, leaves a balance of £21,739, to which should be added the value of the land, namely £8,150, resulting in the total figure of £29,889, which is less than the amount paid by the respondent to the appellants. By another approach, taking a lesser amount of tax and deducting rent, the total sum would be £30,349. The items retained by or the value whereof was paid to the company must affect the value upon whichever basis the Court proceeds to deal with the value of the business. Having regard to the course the matter has taken it is doubtful whether the respondent can invite the Court to adopt a different basis. If the Court could be so invited, it would be submitted, as in *The Commonwealth* v. *Reeve* (1), that the basis adopted was completely and utterly wrong. The correct approach was that adopted in *Pastoral Finance Association Ltd.* v. *The Minister* (2). The fact that a valuable business carried on on a site may be reflected in what an anxious and willing purchaser would pay to an anxious and willing vendor, or a not so anxious and willing vendor is worthy of consideration. But what is that worth if the business is to be sold ? The reason why the appellant company did not take " outside " orders is because until the end of 1946 it was fully engaged on war production. A low rate of capitalization cannot be justified by the suggestion that the company's business was being deliberately tapered off, or that it refused contracts because of the resumption. The company was, in fact, doing all the work it could do right up to the last. The salaries received by the two first-named appellants were received by them as employees of the company, not as directors.

(1) (1949) 78 C.L.R. 410. (2) (1914) A.C. 1083.

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G. E. Barwick K.C., in reply. The Court should take the book figures knowing that there may be possible countervailing adjustments in the circumstances. The method of capitalizing, by its very nature, ignores the real assets. It never condescends to break up the actual assets into their actual values. In the circumstances the tax should be excluded. The matter is at large for the Court, and whether the Court adopt the capitalization method or adopt a summation method, a sum very much in excess of the value of the physical assets ought to be found for the appellants.

Cur. adv. vult.

Oct. 8, 1951.

The Court delivered the following written judgment :—

This is an appeal by the plaintiffs from a judgment of *Webb* J. dismissing with costs an action brought by them under the provisions of the *Lands Acquisition Act* 1906-1936 to recover compensation for the compulsory acquisition of two roods twenty-three and a half perches of land at St. Peters near Sydney in the State of New South Wales. The notification of acquisition was signed by the Governor-General on 9th June 1943, but it was not published in the *Gazette* until 17th April 1947 and therefore did not become effective under ss. 15 and 16 of the Act to vest the land in the defendant until that date. Under s. 29 (1) (*a*) of the Act the compensation is to be assessed according to the value of the land on 1st January 1947.

The original name of the plaintiff company was Rivoli Entertainments Ltd. On 30th June 1943 this company was in the process of changing its name to its present name W. B. Eastaway & Co. Pty. Ltd. By an agreement in writing made on this date between this company and the plaintiffs W. B. Eastaway and N. H. D. Eastaway, who are brothers, and their father E. S. L. Eastaway, after reciting that these plaintiffs had for some time carried on the business of engineers on the subject land and that N. H. D. Eastaway and E. S. L. Eastaway had carried on the business of ironfounders at the same address and that the company proposed to acquire and carry on these businesses, it was agreed that the vendors should sell and the company should purchase all the plant, machinery &c. used in these businesses, all the finished goods, stock-in-trade &c. and the goodwill &c. of these businesses, and all work in progress on the premises of the vendors for the total sum of £35,000 apportioned as provided in the agreement. The agreement provided that the purchase was to take effect from 30th June 1943 and that on the following day, upon satisfaction of the purchase money, possession should be given to the company,

which should thereupon carry on the business so as to maintain the same as a going concern. The agreement also provided that the company would accept a weekly tenancy of the premises upon which the business was carried on at a rental to be agreed between the parties. But no weekly tenancy was ever entered into and none was required because, by a declaration of trust dated 30th June 1943, the plaintiff brothers, who are the registered proprietors of the subject land, declared that they held the land in trust for the company and appointed the company their attorney to complete the transfer of the land to the company. No transfer was ever made, but the result of the agreement and the declaration of trust was that on and after 1st July 1943 the plaintiff company, having paid the purchase money, became the owner of the businesses and assets referred to in the agreement and the equitable owner of the subject land on which these businesses were carried on.

It is not disputed that under these circumstances the company alone is entitled to compensation for the acquisition of the land by the defendant. Substantially the whole of the shares in the company are held by the brothers or their nominees. W. B. Eastaway was the managing director of the company and N. H. D. Eastaway was a co-director. They both gave the whole of their time and attention to the management and conduct of the business. The business specialized in the making of gas-producing plant. It was engaged in important manufacturing contracts for defence during the war and it was for this reason that the gazetting of the notification of acquisition was postponed.

The defendant not only acquired the land. It acquired by agreement most of the plant and machinery used in the business. At the time of the acquisition there was stock-in-trade and work in progress and the defendant also acquired these assets by agreement. Prior to or during the hearing of the action it was agreed that, subject to the question of the effect of the acquisition upon the continuance of the company's business, the value of the land and improvements was £8,150, that the value of the plant and machinery acquired by the defendant was £23,680 5s. 9d. less £1,945 plant retained by the company, a net sum of £21,735 5s. 9d. and that the value of the stock-in-trade and work in progress was £4,024 3s. 6d. The defendant paid the company the sum of £4,024 3s. 6d. owing for the last-mentioned item and also paid the company the sum of £30,000 in discharge or on account of its other obligations. Admittedly these obligations included the payment of the two sums of £8,150 and £21,735, totalling £29,885. But

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the plaintiff company claims that a substantial balance over and above the £30,000 is still due to it.

The plaintiff company is entitled to compensation for the value of the land to it. The action was fought on the common ground that the effect of the acquisition of the land was completely to destroy the ability of the company to carry on business in the future, and it claims that in these circumstances it is entitled to be compensated not only for the improved value of the land and for the plant and machinery taken over by the Commonwealth but also for the loss of the value of the goodwill of the business which was destroyed by the acquisition of the land. The latter item is one which it may be proper to take into account in assessing the value of land acquired by compulsory process, where the loss of the land necessarily results in the closing down of the business which the owner is carrying on upon the land (*The Commonwealth* v. *Reeve* (1)).

Evidence of the value of the undertaking as a going concern was given by two expert witnesses for the plaintiffs and one expert witness for the defendant. These witnesses all based their valuations upon a capitalization of the net profits of the business averaged over a number of selected years. For that purpose they made a number of adjustments to the figures shown in the summarized trading and profit and loss accounts of the company. The experts for the plaintiffs averaged these profits for the five years ended 30th June 1943 to 30th June 1947 inclusive, whilst the expert for the defendant averaged them for the three years ended 30th June 1944, 1945 and 1946. The company only commenced to carry on business on 1st July 1943, so that the net profits of the first year used by the experts for the plaintiffs were the profits of the partnerships and not of the company. They added to the net profits of each of the years ended 1944, 1945, 1946 and 1947 the sum of £1,820 paid as directors' salaries to the two brothers and to each of the years ended 1944, 1945 and 1946 the sum of £343, representing one-third of the preliminary expenses of the formation of the company written off during these years. They then deducted from these adjusted profits income tax at the rate of six shillings in the pound, that being the rate of ordinary company tax prevailing in April 1947, and capitalized the resulting sum £3,248 at five per cent, giving a value for the whole undertaking of £64,960, from which they deducted the above sum of £1,945, leaving £63,015. The expert for the defendant added back the one-third of the preliminary expenses of the formation of the company written

(1) (1949) 78 C.L.R. 410.

off the profits of the years ended 30th June 1944, 1945 and 1946, but not the £1,820 directors' salaries. He also charged the company with the sum of £275 as a notional rent for the value of the land. He deducted from these adjusted profits tax at the rate of six shillings in the pound and capitalized the resulting sum £1,593 at eight per cent and valued the earning capacity of the business at £19,912.

Webb J. thought it advisable to average the net profits for the five years ended 30th June 1943 to 1947 inclusive. In each of these years except the last the trading account showed as an item stock-on-hand £400. This was apparently a nominal value. For the year ended 30th June 1947 the stock-on-hand and work in progress was listed and valued and shown at £1,900 3s. 1d. The inclusion of this year without any adjustment for this increase in the value of this item would result in the average profits of the five years including an amount of £1,500, the difference between these two sums. The agreement of 30th June 1943, however, provided that the sum to be paid by the company for the purchase of the stock-on-hand and work in progress was £4,125 4s. 0d. and his Honour accepted this figure as the real value of this item on 1st July 1943. Accordingly he adjusted the net profits for the five years by treating the difference between £4,125 and £1,900 as a loss over this period. His Honour accepted the value of the land and improvements at the agreed sum of £8,150 as one item in the computation of the amount of compensation and then proceeded to value the plant, machinery and goodwill as a separate composite item. This led him also to deduct from the annual net profits the sum of £407 10s. 0d., representing a notional rental for the land calculated at five per cent on the £8,150. He refused to write back into the net profits the directors' salaries as, in his opinion, the sum of £1,820 represented no more than reasonable remuneration for their work done in the business. After making certain other adjustments his Honour reached a sum of £1,050 as the average net profits of the business. He capitalized this sum at six per cent, the result being, according to him, £17,150, apparently a mistake for £17,500. To this sum of £17,150 he added the value of the land and buildings £8,150 and found the total compensation, other than the amount of £4,024 3s. 6d. paid for the stock-in-trade and work in progress, to be £25,300. As the defendant had already paid £30,000 to the plaintiffs, he found that no further sum was payable and dismissed the action with costs.

We are of opinion that it is clear that the plaintiff company is entitled to at least £29,885, that is to say, the amount already

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mentioned of the agreed value of the land and improvements and the agreed net value of the plant and machinery taken over. If this is the total compensation it has been overpaid, though not to the extent found by his Honour, and the appeal should be dismissed with costs. But is the plaintiff company not entitled to a greater sum than £30,000 ? It was not engaged in the business of buying and selling land and engineering plant and machinery. It was using these assets for the purpose of carrying on a business and if the value of the business based on its earning capacity exceeded the value of the tangible assets and that business was destroyed by the acquisition of the land, the compensation to which the plaintiff company is entitled should, having regard to the way the case was fought, be taken to include an amount equal to the value of the whole undertaking regarded as a going concern; for it was deprived of that sum by the loss of the land and that was the value of the land to it. The expert witnesses quite rightly sought to ascertain this value by examining the net profits made in the past in order to estimate what the probable future profits of the business would be. They should then have sought to ascertain what rate of profit would be a fair return on capital invested in such a business for the assumption is that a reasonable vendor would be willing to sell the business and a reasonable hypothetical purchaser would be willing to purchase it for a capital sum which would return this rate of profit (*Commissioner of Succession Duties (S.A.)* v. *Executor Trustee and Agency Co. of South Australia Ltd.* (1)). Unfortunately the plaintiffs' experts, in fixing a capitalization rate of five per cent, appear to have taken as a guide the rate of return the plaintiff company could reasonably expect to obtain if it reinvested the proceeds of sale not in a business but in investments such as mortgages, Commonwealth loans and shares in companies registered on the stock exchange. The fact that the proceeds of sale of a business when so reinvested will return a smaller sum than the net profits derived from the business is not a factor that can be taken into account in the assessment of compensation (*Cunningham* v. *The Commonwealth* (2)).

But, in deciding what would be a reasonable rate of capitalization, it is material to take into account the nature of the tangible assets in which the capital is invested, for this bears on the safety of the investment. In the present case it is also material, we think, not to overlook the fact that the threat of acquisition existed after June 1943 and that this prevented the plaintiff

(1) (1947) 74 C.L.R. 358, at pp. 361, 362.

(2) (1948) 79 C.L.R. 424.

company modernizing and enlarging its plant and machinery and thereby increasing its output and that, if there had been no acquisition, the profits made in the past would probably have improved in the future. Taking all these matters into consideration, we do not disagree with his Honour's decision to capitalize the net profits at what would otherwise have been the somewhat low rate of six per cent.

The amount of these profits requires consideration. There is no satisfactory explanation why the stock-on-hand was shown in the opening entry in the books of the plaintiff company at £400 when in the agreement of sale the stock-on-hand and work in hand was valued at £4,135. In the absence of such an explanation it is impossible to discover whether in the years ended 30th June 1943 to 1947 inclusive this item showed a loss as it would if the opening stock should have been £4,135 or a profit as it would if the opening figure of £400 was correct. On the whole, we think it best to take the three years ended 30th June 1944, 1945 and 1946 recommended by the expert for the defendant as giving the best clue to the probable extent of the company's profits in the future. We can see no reason for writing back the £1,820 into these profits. There is no evidence that this sum was more than reasonable remuneration for the work done by the brothers and as such just as much part of the expenditure incurred in earning the net profits as the salaries or wages of any other employee. On the other hand, we see no reason for adjusting the net profits by deducting company tax of six shillings in the pound. Such a deduction should be made in ascertaining the net profits of a company available for the payment of dividends because under the existing tax laws this sum is not credited against the tax a shareholder has to pay on his dividends. But the hypothetical purchaser would in the present case not be a purchaser of the shares of the plaintiff company but of its business. An individual purchaser would never have to pay such a tax. Even if the purchaser was a company, taxes that a company pays on its income should not be taken into account in estimating what it would pay for a business any more than taxes that an individual has to pay on his income (cf. *Billingham* v. *Hughes* (1)). If the hypothetical purchaser is regarded as estimating the price he would be willing to pay upon the net income the business would yield to him after payment of his income tax, it would be necessary to adopt a different rate of capitalization and to take into account in some way the effect of graduated taxation upon potential buyers of varying incomes in the attempt to discover what the hypo-

(1) (1949) 1 K.B. 643.

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thetical purchaser would be prepared to give. Since the capitalization is of the net profits of the business as a whole there is no justification for charging against these profits a notional rental for the use of the land and buildings. If such a charge was justified a similar charge would have to be made for the use of the plant and machinery. The net profits which should be averaged are, in our opinion, the net profits as shown in the company's accounts for the years ended 30th June 1944, 1945 and 1946 adjusted only to the extent of writing back the sums of £343 written off for preliminary expenses. This makes the net profits for the three years £2,846, £1,933 and £2,870 respectively, an average in round figures of £2,550. This profit capitalized at six per cent gives a value of £42,500. But this sum represents the whole amount the plaintiff company could reasonably expect to obtain for the sale of the whole undertaking as a going concern and therefore for the acquisition by the purchaser not only of the goodwill but of the whole of the tangible assets used in the business. The plaintiff company retained a number of the tangible assets. It retained plant valued at £1,945. It also retained the items of sundry debtors £3,933, motor cars £242 19s. 10d. and £1,537 credit in the bank account. These sums total £7,657 and this sum must be deducted from the £42,500, leaving a balance of £34,843. This is, in our opinion, the sum at which the total compensation other than the sum of £4,024 3s. 6d. paid for the stock-in-trade and work in progress should be assessed. Of this sum the defendant has already paid £30,000 on account.

The appeal should be allowed with costs, the judgment below should be set aside, and in lieu thereof there should be judgment for the plaintiffs for the sum of £4,843 with costs.

Appeal allowed with costs. Judgment appealed from set aside. In lieu thereof enter judgment for the plaintiffs for the sum of £4,843 *with costs.*

Solicitors for the appellants, *Walter Linton & Bennett.*

Solicitor for the respondent, *D. D. Bell,* Crown Solicitor for the Commonwealth.

J. B.