NO. 1235—HIGH COURT OF JUSTICE (KING'S BENCH DIVISION)—
16TH JANUARY, 1942

COURT OF APPEAL—5TH MAY, 1942

HOUSE OF LORDS—14TH AND 15TH DECEMBER, 1942

BEAK (H.M. INSPECTOR OF TAXES) v. ROBSON(1)

Income Tax, Schedule E—Emoluments of office—Payment in consideration of restrictive covenant in service agreement.

The Respondent had been director of a limited company for many years, without any written service agreement. In 1937 an agreement (terminable by either side at six months' notice) was entered into by which he agreed to continue to serve as director and manager of the company for five years at a salary of £2,000 per annum and bonuses calculated on the same lines as in previous years. By the last two clauses of the agreement, the Respondent covenanted, in consideration of the payment to him of £7,000 on the execution of the agreement, that if the agreement were determined by notice given by him or by his breach of its provisions he would not compete directly or indirectly with the company within a radius of fifty miles of its place of business until the five years had expired.

On appeal by the Respondent against the assessment of the £7,000 to Income Tax under Schedule E, the General Commissioners held that it was a payment for giving up a right wholly unconnected with his office and operative only after he ceased to hold that office, and they discharged the assessment.

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

CASE

Stated under the Income Tax Act, 1918, Section 149, by the Commissioners for the General Purposes of the Income Tax Acts for the Division of Newcastle City in the County of Northumberland for the opinion of the King's Bench Division of the High Court of Justice.

At a meeting of the Commissioners for the General Purposes of the Income Tax Acts for the Division of Newcastle City in the County of Northumberland held at Cathedral Buildings, Dean Street, Newcastle-upon-Tyne, on Monday, 16th December, 1940, John Paxton Robson (hereinafter called " the Respondent ") appealed against an assessment to Income Tax in the sum of £7,000 for the year ending 5th April, 1939, made upon him under the provisions of Schedule E of the Income Tax Acts.

1. The Respondent was at all times material to this appeal a director and manager of William Mathwin & Son (Newcastle), Ltd. (hereinafter referred to as " the company ").

2. The company is a private limited liability company carrying on the business of coal exporters, coal merchants and shipbrokers, principally with the Baltic countries. A copy of its memorandum and articles of association, marked " A ", is annexed and forms part of this Case(2).

3. By its articles of association, numbers 71 and 72, the directors of the company shall not be less than two nor more than five unless otherwise determined in general meeting. Two who are named are permanent directors

(1) Reported (C.A.) [1942] 2 K.B. 149; (H.L.) [1943] A.C. 352.

(2) Not included in the present print.

and not subject to retirement by rotation. By article 73 the permanent directors have power to appoint other directors for such period and at such remuneration as they may think fit, and they may remove or dismiss such directors.

4. The Respondent started with the company in 1904 and became a director in 1923. His remuneration for a number of years has been on the basis of a salary of £1,000 in 1928 rising to £2,000 in 1936 and, in addition, bonuses depending on the prosperity of the company. He had no written agreement of service with the company prior to the one now in question.

5. An agreed comparative statement of the company's profits and of the remuneration actually paid to the Respondent over a number of years is attached, marked " B ", and forms part of this Case(1).

6. The two permanent directors have in recent years devoted less time to the business and as a consequence more and more work fell on the shoulders of the Respondent, who had a large personal connection with the company's customers on the Continent.

7. In 1937 informal discussions took place between the company and the Respondent as to their future relations, the company desiring a more permanent arrangement as the Respondent's services and connection were valuable to the company.

8. As a result of these discussions an agreement was drawn up by which the Respondent agreed to continue to serve the company as director and manager for a term of five years from 1st April, 1937 (but terminable as thereinafter provided), for which he was to be paid a salary of not less than £2,000 per annum together with such bonuses as the board of directors of the company should from time to time determine, such determination to have regard to the same consideration as determined the bonuses paid to the Respondent in the past. It was provided that the agreement should be terminable by either party by six months' notice in writing expiring on 30th September, 1940, or at any time thereafter.

9. At the end of the agreement, in clauses 7 and 8, the Respondent also bound himself, if the agreement should be determined by notice given by him or by breach by him of the provisions of the agreement, on consideration of the payment of a sum of £7,000, not (without the consent of the company) directly or indirectly to carry on the business of coal exporter, coal manager or shipbroker within fifty miles of Newcastle-upon-Tyne for a period from such determination until the expiration of five years from 1st April, 1937.

10. A copy of the agreement dated 4th October, 1937, is annexed, marked " C ", and forms part of this Case(1).

11. A copy of the company's minute of 4th October, 1937, relating to the agreement is also annexed, marked " D ", and forms part of this Case(1).

12. The said sum of £7,000 was paid to the Respondent on the execution of the agreement, and on 20th August, 1940, an assessment under Schedule E of the Income Tax Act, 1918, was raised.

13. The Respondent gave evidence at the hearing, which we accepted, as follows.

He started with the company in 1904 and became a director in 1923. Since 1933 when the senior director had a serious operation, the Respondent had, with another director, taken an important part in the business of the

(1) Not included in the present print.

company. There was no particular reason for a five-year period nor for the particular date of September, 1940, beyond the fact that in 1937 it was desired by both sides to have a more permanent arrangement than under the articles. There had been discussions between him and the other active director whether they should start business on their own account. They had friends on the Continent who would support them. Both he and the other active director performed the major part of the work of the company covering the area of France, Germany, Denmark, Norway, Sweden, Finland, Latvia and Lithuania. Although the company was one of the principal coal exporting concerns in the United Kingdom, he thought he would have no difficulty in starting business on his own account.

14. It was contended on behalf of the Respondent that clauses 1 to 6 of the agreement constituted an ordinary service agreement; that clauses 7 and 8 were a restrictive covenant, and that the sum of £7,000 received did not arise out of the Appellant's office as director and manager and, therefore, was not liable to Income Tax under the provisions of Schedule E.

The following cases were referred to:—

Duke of Westminster v. *Commissioners of Inland Revenue,* 19 T.C. 490; 51 T.L.R. 467.

Hunter v. *Dewhurst,* 16 T.C. 605; 145 L.T. 225.

Prendergast v. *Cameron,* 23 T.C. 122; [1940] A.C. 549—(distinguished).

15. It was contended on behalf of the Crown that the £7,000 was an emolument of the Respondent's office and as such assessable to Income Tax under Schedule E.

The following cases were referred to:—

Herbert v. *McQuade,* 4 T.C. 489; [1902] 2 K.B. 631.

Prendergast v. *Cameron,* 23 T.C. 122; [1940] A.C. 549.

Hunter v. *Dewhurst,* 16 T.C. 605; 145 L.T. 225—(distinguished).

16. We, the Commissioners, gave our decision as follows:—

We are of opinion that the contract of 4th October, 1937, is a bona fide contract, that it contains two agreements—one in clauses 1 to 6 being an ordinary service agreement complete in those clauses, and another in clauses 7 and 8 for a payment for the giving up of a right wholly unconnected with the Respondent's office as director and manager and operative only after he ceased to hold that office.

We discharged the assessment.

17. The Inspector, on behalf of the Crown, immediately after the determination of the appeal declared his dissatisfaction therewith as being erroneous in point of law and in due course required us to state a Case for the opinion of the High Court pursuant to the Income Tax Act, 1918, Section 149, which Case we have stated and sign accordingly.

A. E. BELL, W. TORRY, } Commissioners for the General Purposes of the Income Tax Acts for the Division of Newcastle City in the County of Northumberland.

The case came before Lawrence, J., in the King's Bench Division on 16th January, 1942, when judgment was given against the Crown, with costs.

The Attorney-General (Sir Donald Somervell, K.C.) and Mr. Reginald P. Hills appeared as Counsel for the Crown, and Mr. Cyril L. King, K.C., and Dr. J. Charlesworth for the Respondent.

JUDGMENT

Lawrence, J.—This is an appeal by the Crown from the General Commissioners for the Division of Newcastle City, and the question is whether a payment of £7,000 to the Respondent by William Mathwin & Son (Newcastle), Ltd., was a profit from having or exercising the office of director and manager of that company within the meaning of Rule 1 of the Rules applicable to Schedule E.

The Respondent was first employed by this company in 1904 and became a director of the company in 1923, and from then onwards was paid salary and bonuses calculated in a certain way. In 1937 the company and the Respondent entered into an agreement for 5 years, under which the Respondent was to continue to serve as director and manager. By clause 3 he was to devote his time to the company and not to enter into any other business of a similar nature during the spare time that he had. He was to receive a salary of £2,000 per annum and he was to receive bonuses calculated in the same way as the bonuses which he had previously received. By clause 6 the agreement was to be terminable by either party by six months' notice in writing expiring on 30th September, 1940, or at any time thereafter, the agreement itself being made on 4th October, 1937. The agreement concludes with clauses 7 and 8 which are in the following terms: " 7. In consideration " of the restrictive covenant on the part of Mr. Robson contained in the " next succeeding clause hereof the Company shall on the execution hereof " pay to Mr. Robson the sum of £7,000. 8. If this agreement shall be " determined by notice given by Mr. Robson to the Company under clause 6 " hereof or by any breach by him of the provisions of this agreement then " from such determination or breach until the determination of a period of " five years from 1st April, 1937, Mr. Robson shall not without the consent " in writing of the Company either solely or jointly with or as manager or " agent for any other person persons or company directly or indirectly carry " on or be engaged concerned or interested in the business of Coal Exporter, " Coal Merchant or Shipbroker within fifty miles of Newcastle-upon-Tyne."

The General Commissioners have decided that that part of the agreement contained in clauses 7 and 8, under which the Respondent was paid £7,000 in consideration of entering into this restrictive covenant, was separate from the rest of the agreement; they said that in effect the agreement contained two agreements, one being an ordinary service agreement complete in clauses 1 to 6, and another in clauses 7 and 8 for a payment for the giving up of a right wholly unconnected with the Respondent's office as director and manager and operative only after he ceased to hold that office.

In my opinion, the General Commissioners were right in holding that the agreement contained in clauses 7 and 8 was for a payment for the giving up of a right wholly unconnected with the Respondent's office as director and manager and operative only after he ceased to hold that office. The Attorney-General and Mr. Hills have put the argument for the Crown in this way. They have drawn attention to the possible variant of this agreement which might arise if a director had entered into an agreement to serve for a certain sum annually and the same director had entered into a restrictive covenant with reference to the period after he ceased to be a director; and they said that in such circumstances it would be impossible for the director to avoid paying tax upon the whole of his salary on the argument that some part of that salary was paid to him in consideration of the restrictive covenant. I

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think it is probably right that it would be impossible for a director in such circumstances so to avoid tax, because he would then have received the annual sum ostensibly as the salary of his office but had not quantified or valued the restrictive covenant into which he had entered. The Attorney-General then argued that if that is so it must be equally true that even if he does quantify or value the restrictive covenant that can make no difference; he said that the payment of this £7,000 and the restrictive covenant are part and parcel of the conditions of service in the office, and that, therefore, the £7,000 must be regarded as profit from having or exercising the office, and he said that the word " therefrom " may include a period of time, or profits which are connected with a period of time, after the cessation of the office.

In my opinion, the arguments on behalf of the Crown are not sound. It appears to me that the £7,000 comes not from having or exercising the office, but from absence from employment in a certain area after the cessation of the office, and I think that the valuation of the restrictive covenant, coupled with the fact that the restrictive covenant applies to a period only when the office-holder has ceased to hold the office, entirely distinguishes the case from the case in which a salary is paid and the agreement contains a restrictive covenant without any quantification of, or valuation of, that restrictive covenant.

Several cases were alluded to, but neither side has really relied upon the *Hunter* v. *Dewhurst* case, 16 T.C. 605. I, therefore, do not think it necessary to review those cases or to base my judgment in any way upon that case. In the case of *Herbert* v. *McQuade,* 4 T.C. 489, cited by Mr. King and commented upon by Mr. Hills in reply, Mr. King relied upon a passage in Stirling, L.J.'s judgment at page 501 where he said: " I think that a profit " accrues by reason of an office when it comes to the holder of the office " as such—in that capacity—and without the fulfilment of any further or " other condition on his part ". Those words do seem to me to offer some support to the view which I am taking in this case, and they were laid down by Stirling, L.J., in perfectly general terms and, as Mr. Hills informed me, are constantly relied upon by the Crown.

For these reasons I am of opinion that the decision of the General Commissioners was correct and the appeal will be dismissed with costs.

The Crown having appealed against the decision in the King's Bench Division, the case came before the Court of Appeal (Lord Greene, M.R., du Parcq, L.J., and Lewis, J.) on 5th May, 1942, when judgment was given unanimously against the Crown, with costs, confirming the decision of the Court below.

The Attorney-General (Sir Donald Somervell, K.C.) and Mr. Reginald P. Hills appeared as Counsel for the Crown, and Mr. Cyril L. King, K.C., and Dr. J. Charlesworth for the Respondent.

JUDGMENT

Lord Greene, M.R.—In my opinion, this is a clear case and the decision of Lawrence, J., was manifestly right.

The Respondent, on 4th October, 1937, entered into an agreement with a company in whose employment he had been for some time, whereby he was to be employed for a term of five years as director and manager, at a salary

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there stated. The agreement contained clauses under which, in the event of the Respondent determining the agreement by notice, as he was entitled under one of its clauses to do, or committing a breach of it which led to a determination, he covenanted for a stated period not, without the consent of the company, (putting it shortly) to be engaged or interested in the business of a coal exporter within a radius of 50 miles of Newcastle-upon-Tyne.

The parties had fixed upon a sum of money, namely, £7,000, which was to be paid to the Respondent on the execution of the contract in consideration of his entering into that covenant. The sum was duly paid, and the Crown claimed that it was remuneration from his office of director and manager and taxable accordingly under Schedule E of the Income Tax Act, 1918.

It is to be observed that the way in which the parties have chosen to contract is one in which the obligations flowing from the contract of service and the remuneration to be received by the Respondent in respect of that service are entirely separated from the covenant and the consideration which is given for it. Separate considerations are fixed for the two things: one consideration for the service, a totally different consideration for the covenant. Breach of the contract of service has nothing in the world to do with breach of the covenant. Conversely, breach of the covenant would have nothing in the world to do with the contract of service. The two things are quite distinct, with separate considerations and separate obligations provided for both.

It seems to me that those facts would by themselves be quite sufficient to dispose of this case. The sum of £7,000 is not paid to the Respondent for performing the services in respect of which he is chargeable under Schedule E. The consideration which he has to give under the covenant falls to be given not during the period of his employment, but after its termination. In fact, he is selling to the company for a sum of £7,000 the benefit of a covenant which will only come into effect when the service is concluded. It seems to me that to say that that £7,000 is a profit or remuneration from his office is to ignore the real nature of the transaction.

But it is said that this covenant which he gives is a condition of the service into which he enters by agreeing to serve as director and manager. That observation is no doubt true, in the sense that this particular provision with regard to the covenant is found in the contract of service and no doubt the parties would not have entered into that contract of service unless that term had been agreed upon; but it seems to me impossible to proceed from that to the further step and say that because this provision is a condition of the service in that sense, therefore the remuneration paid is remuneration from the service. It seems to me quite impossible to suggest that.

I put the example in the course of the argument of a man appointed a manager for a period of years at a definite remuneration. One of the terms might be that while the employment continues he is to use his motor car for the purposes of his employers. The contract might go on to say that on the termination of the employment he, in consideration of a sum paid down, would transfer the motor car to the employers as their own property. It seems to me it would be quite impossible to suggest in such a case that the sum he received in consideration for the undertaking to transfer the motor car would be remuneration from his employment.

I cannot myself see any difference between that case and the present. In each case the employee is contracting to sell something to his employer

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at the termination of his agreement and receives a particular and specific consideration for it.

It was suggested then that covenants of this kind, namely, covenants by employees not to compete after the termination of their service, are commonly found in managerial agreements without there being any specific consideration allocated to them. That no doubt is perfectly true and in some cases covenants of that kind may be valid in law; but, quite apart from the question of their validity, it is common knowledge that many managerial agreements do contain clauses of that kind. If, for a fixed remuneration, a man agrees to serve and without any additional remuneration agrees to enter into such a covenant, I cannot myself see how it can be suggested that the covenant in some way or another must be regarded as something outside the contract of service.

It was suggested that if the Respondent was successful in the present case it would be necessary in all such cases as those to which I have referred—it would be legitimate, at any rate—to segregate the covenant not to compete from the covenants relating to the service and attribute some apportioned part of the consideration to the former, with the result that parts of salaries would escape taxation under Schedule E. Arguments of that kind can be dealt with if and when anyone has the hardihood to make such a claim; but that is not the present case. The fact that the parties in the present case could, if they had so desired, have cast their agreement in a form under which for increased remuneration the Respondent agreed to serve and then merely gave this covenant, is beside the point. They have not done that. They have entered into an agreement which, although contained in one document and although made on the same occasion and although connected in the way I have indicated, really relates to two quite different matters, one the period of service, one something that is to happen after the service. The fact that they have decided upon and allocated to that covenant an agreed consideration seems to me to take it right outside the class of case which was referred to in argument and which I have just mentioned.

That really is enough to dispose of the case. In my opinion, the appeal fails and should be dismissed with costs.

du Parcq, L.J.—I agree and I do not think I can usefully add anything.

Lewis, J.—I have nothing to add to the judgment of the Master of the Rolls, with which I agree.

The Attorney-General.—I would like to ask, subject possibly to terms as to costs, for leave to appeal to the House of Lords. It is a novel point. I am told a number of contracts of this kind are taking this form, no doubt in many cases for tax purposes. It raises a question, in my submission, of importance and principle and, subject to this individual taxpayer being protected with regard to costs, I would ask for leave to appeal.

Lord Greene, M.R.—Mr. King, have you any objection to having this matter brought to the attention of the House of Lords, if you are completely indemnified against costs?

Mr. King.—No, my Lord, I do not think I can say I have, if the indemnity is complete. Of course, it is not merely a matter of party and party costs in these matters. If my friend will give me an indemnity, I do not think I can raise any objection, if your Lordships think it fit otherwise.

The Attorney-General.—I think the most drastic term is this, is not it, that the Crown undertakes not to seek to disturb the Order as to costs in this Court. Therefore that is finished, and in the House of Lords we pay the costs of the Respondent. I have forgotten whether on previous occasions it has been solicitor and client or party and party, but I am quite content to be in your Lordships' hands with regard to that.

Lord Greene, M.R.—I have never been informed, Mr. Attorney—perhaps you know—what is the form of Order in such cases that commends itself to the House of Lords. I did understand at one time that the House of Lords did not think it proper that in this Court a term should be imposed, or an undertaking should be taken, with regard to the incidence of costs in the House of Lords which the House of Lords regarded as purely within its own competence. If an undertaking is given, as distinct from the imposition of a term, is there any objection so far as the House of Lords is concerned?

The Attorney-General.—No, my Lord. I have had, I do not say quite a number, but two or three cases which have gone to the House of Lords on these terms and I have never known any objection raised there on the basis that the Crown undertakes not to seek to disturb the Order as to costs in this Court. That, I think, is the nearest one gets to impinging on the jurisdiction, because anyone can undertake to pay somebody else's costs, I suppose, but the House of Lords could deal with the Order of this Court as to costs; but I have never heard any objection taken.

Lord Greene, M.R.—We think that the proper terms should be those suggested by the Attorney-General, subject to this, that the costs which he would undertake to pay in the House of Lords would be solicitor and client costs of the Respondent. He leaves the matter in the hands of the Court whether such costs should be solicitor and client or party and party, and we all think it should be solicitor and client; but, of course, the costs in this Court will follow the ordinary rule. They will only be party and party costs.

Mr. King.—In saying "solicitor and client" your Lordship is not saying "solicitor and own client"?

Lord Greene, M.R.—That is a phrase I never use unless I am compelled to by some authority.

Mr. King.—If your Lordship pleases.

The Crown having appealed against the decision of the Court of Appeal, the case came before the House of Lords (Viscount Simon, L.C., and Lords Atkin, Thankerton, Russell of Killowen and Porter) on 14th and 15th December, 1942, and on the latter date judgment was given unanimously against the Crown, with costs, confirming the decision of the Court below.

The Attorney-General (Sir Donald Somervell, K.C.) and Mr. Reginald P. Hills appeared as Counsel for the Crown, and Mr. Cyril L. King, K.C., and Dr. J. Charlesworth for the Respondent.

JUDGMENT

Viscount Simon, L.C.—My Lords, in this case the Crown contends that a payment of £7,000 to the Respondent by a private company called William Mathwin & Son (Newcastle), Ltd. under a written agreement between them dated 4th October, 1937, was a "profit from the office" of director and

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manager of that company within the meaning of Rule 1 of the Rules applicable to Schedule E of the Income Tax Act, 1918. The Commissioners for the General Purposes of the Income Tax Acts for the Division of Newcastle City decided against this contention and were required to state a Case for the opinion of the High Court. Lawrence, J., upheld the decision of the General Commissioners, and the Crown's appeal to the Court of Appeal (Lord Greene, M.R., du Parcq, L.J., and Lewis, J.) failed. Leave was given to the Attorney-General to appeal to this House on his undertaking that the Crown would pay the solicitor and client costs of the Respondent in any event, and that the Order as to costs in the Court of Appeal would not be disturbed. Notwithstanding the able arguments addressed to us by the Attorney-General and by Mr. Hills, I am of the opinion that the decision appealed against is right and that the present appeal must be dismissed.

The written agreement of 4th October, 1937, recites that Mr. Robson has for some years served the company as a director and manager at a fixed salary with bonuses, and that his service is terminable by short notice on either side, but that his services and connection are important to the goodwill of the business. The provisions of the agreement are then set out in eight numbered clauses. Clauses 1 to 6 deal with the terms of Mr. Robson's service as director and manager of the company. He is to serve for a term of five years from 1st April, 1937, at a salary at the rate of not less than £2,000 per annum, subject to a right in either party by six months' notice in writing to terminate the agreement not earlier than 30th September, 1940. Provision is also made for the granting of bonuses to Mr. Robson out of the company's profits, and during his service he is not to enter into any other business of a similar nature without the previous consent of the board. So far the clauses of the contract constitute a service agreement pure and simple.

Clauses 7 and 8 of the agreement deal with a different matter. Clause 8 binds Mr. Robson, if his service in the company is terminated before 1st April, 1942, not to be concerned or interested in the business of coal exporter, coal merchant, or shipbroker within fifty miles of Newcastle-on-Tyne until the date of 1st April, 1942, is reached. And clause 7 provides that in consideration of this restrictive covenant the company shall on the execution of the agreement of 4th October, 1937, pay to Mr. Robson the sum of £7,000. This sum has been duly paid and, as I have said, the Crown claims that it constitutes profit from Mr. Robson's office of director and manager and is taxable accordingly under Schedule E.

The Master of the Rolls has indicated the answer to this claim in very clear language. In the agreement before us, the obligations flowing from the contract of service and the remuneration to be received by the Respondent in respect of that service are entirely separate from the restrictive covenant and the consideration which is given for it. The sum of £7,000 is not paid for anything done in performing the services in respect of which Mr. Robson is chargeable under Schedule E. The consideration which he has to give under the covenant is to be given not during the period of his employment, but after its termination. He is giving to the company for a sum of £7,000 the benefit of a covenant which will only come into effect when the service is concluded. I agree with the Court of Appeal in the view that to treat this £7,000 as a profit arising from the Respondent's office is to ignore the real nature of the transaction. It is quite true that, if he had not entered into the agreement to serve as a director and manager, he would

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not have received £7,000. But that is not the same thing as saying that the £7,000 is profit from his office of director so as to attract tax under Schedule E.

The Attorney-General points out that it is not uncommon in managerial agreements to include a covenant not to compete after the service is terminated without any separate consideration being allocated to the covenant, and it was suggested that a decision in favour of the Respondent in this case might involve the apportionment of the remuneration which a manager receives under his agreement between the profit of his office and the price paid to secure the covenant. I propose to say nothing about that, and to decide the present case purely upon the terms of the agreement of 4th October, 1937. That agreement is admitted to be a bona fide contract and, so regarded, the £7,000 cannot properly be treated as a profit arising from the Respondent's office or employment.

I move that the appeal be dismissed with costs to the Respondent as between solicitor and client.

Lord Atkin.—My Lords, I agree.

Lord Thankerton.—My Lords, I agree.

Lord Russell of Killowen.—My Lords, I also agree.

Lord Porter.—My Lords, I agree also.

Questions put:

That the Order so far as appealed from be reversed.

The Not Contents have it.

That the Order appealed from be affirmed, and that the appeal be dismissed with costs to the Respondent as between solicitor and client.

The Contents have it.

[Solicitors:—Solicitor of Inland Revenue; Hyde, Mahon & Pascall, for Wilkinson & Marshall, Newcastle-upon-Tyne.]