HIGH COURT OF JUSTICE (CHANCERY DIVISION)—
23RD, 24TH AND 25TH MARCH AND 6TH APRIL 1966

COURT OF APPEAL—8TH, 9TH, 10TH AND 13TH FEBRUARY 1967

HOUSE OF LORDS 11TH, 12TH, 13TH, 17TH, 18TH AND 19TH JUNE AND 23RD OCTOBER 1968

Campbell and Another *v.* Commissioners of Inland Revenue[1]

Income tax—Annual payment—Payments agreed to be applied in purchasing payer's business—Whether payable under deduction of tax—Income Tax Act 1952 (15 & 16 *Geo.* 6 & 1 *Eliz.* 2, *c.* 10), *ss.* 169 *and* 447(1)(*b*).

The Appellants were trustees of a charitable trust set up to acquire a tutorial business carried on by T Ltd. On 30*th March* 1961 *T Ltd. covenanted to pay to the Appellants annually on* 5*th April for seven years commencing* 5*th April* 1961 80 *per cent. of its trading profits chargeable to income tax (less capital allowances), the remaining* 20 *per cent. being retained to meet its profits tax liability. There was a clear understanding by the directors and shareholders of T Ltd. and the Appellants that the net sums payable under the deed of covenant, together with any income tax recoverable under s.* 447(1)(*b*), *Income Tax Act* 1952, *would be used by the Appellants to purchase the business of T Ltd.*

The sums falling due under the covenant on 5*th April* 1961 *and* 1962 *were expressed to be paid to the Appellants under deduction of tax at the standard rate. They were applied in purchasing the trade fixtures, furniture, books, etc., of T Ltd. and part of its goodwill. The Commissioners of Inland Revenue refused the Appellants' claims to repayment under s.* 447 (1) (*b*) *for the years* 1960–61 *and* 1961–62 *of the tax expressed to have been deducted from the payments.*

On appeal it was contended for the Crown (i) *that the payments, not being paid by T Ltd. without conditions or counter-stipulations, were not "annual payments" within s.* 447(1)(*b*), *and* (ii) *that they had not been applied to charitable purposes only. The Special Commissioners found that the understanding as to the use of the covenanted payments was a condition or counter-stipulation attached to the deed of covenant and held that payments were not annual payments, but that they had been applied to charitable purposes.*

Held, (1) *that the payments were not income of the Appellants, because* (*a*) (*per Lords Dilhorne, Guest and Upjohn*) *the Appellants were contractually bound to return them to the payer, or* (*b*) (per *Lords Hodson, Guest and Donovan*) *they were instalments of capital in the hands of the Appellants, being paid under a contract which required them to be applied in purchasing the business;* (2) *that they were applied to charitable purposes only.*

Earl Howe *v.* Commissioners of Inland Revenue 7 T.C. 289; [1919] 2 K.B. 336 *applied. Reasoning in* Commissioners of Inland Revenue *v.* National Book

[1] Reported [1966] Ch. 439; [1966] 2 W.L.R. 1448; 110 S.J. 314; [1966] 2 All E.R. 736; (C.A.) [1967] Ch. 651; [1967] 2 W.L.R. 1445; 111 S.J. 155; [1967] 2 All E.R. 625; (H.L.) [1970] A.C. 77; [1968] 3 W.L.R. 1025; 112 S.J. 864; [1968] 3 All E.R. 588.

League 37 T.C. 455; [1957] Ch. 488 *in part disapproved.* Dictum *of Lord Normand in* Commissioners of Inland Revenue *v.* Corporation of London (as Conservators of Epping Forest) 34 T.C. 293, at page 324; [1953] 1 W.L.R. 652 *explained.*

CASE

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

1. At a meeting of the Commissioners for the Special Purposes of the Income Tax Acts held on 4th and 5th November 1964 the Trustees of the Davies's Educational Trust (hereinafter called "the trustees" and "the Trust" respectively) appealed against the refusal by the Commissioners of Inland Revenue of claims made by the trustees under s. 447(1)(*b*) of the Income Tax Act 1952 for exemption from income tax chargeable for the years 1960–61 and 1961–62 on payments received by the trustees under a deed of covenant dated 30th March 1961.

2. Shortly stated, the questions for our decision were: (*a*) whether payments made under the said deed of covenant were annual payments within the meaning of s. 447(1)(*b*); and (*b*) if so, whether those payments had been applied to charitable purposes only within the meaning of that subsection.

3. Cecil Arthur Barber, F.C.A., senior partner in Barber & Co., chartered accountants, gave evidence before us.

4. The following documents were proved or admitted before us:

(1) A brochure giving the history and activities of Davies's.

(2) The memorandum and articles of association of Davies's (Tutors) Ltd. (hereinafter called "Tutors").

(3) A declaration of trust dated 29th March 1961.

(4) A notification dated 18th August 1961 of the registration of the Trust on the Register of Charities.

(5) The memorandum and articles of Association of Davies's Educational Developments Ltd. (hereinafter called "Developments").

(6) A deed of partnership dated 5th April 1962 between Tutors and Developments.

(7) A deed of covenant dated 30th March 1961 by Tutors in favour of the Trust.

(8) A bundle of correspondence between Barber & Co. and the Inland Revenue Department.

(9) A letter dated 31st March 1962 from Mr. C. A. Barber containing the valuation of the goodwill of Tutors.

(10) The accounts of the Trust for the period ended 5th April 1962 and the year ended 5th April 1963.

(11) Service agreements entered into by M. R. Campbell, W. N. McBride and P. J. Hall with Tutors and Developments, trading together in partnership under the name of style of Davies's.

Copies of such of the above as are not annexed hereto as exhibits(1) are available for inspection by the Court if required.

---

(1) Not included in the present print.

5. As a result of the evidence, both oral and documentary, adduced before us we find the following facts proved or admitted:

(*a*) Davies's, a well-known and reputable organisation, was started in 1927 by Vernon Davies for providing tuition for entry to the Administrative Class of the Civil Service. After the last war this "civil service" work declined, and the organisation branched out into different forms of tuition. At the material times for this appeal the main branches of tuition were:

Schools of English in London, Cambridge and Hove;

Senior tutorial schools in London and Hove;

Junior tutorial schools in London;

Preparatory schools for boys in London;

A secretarial training college in London.

The founder of Davies's died unexpectedly in 1952, and thereafter the organisation has been under the control of M. R. Campbell, W. N. McBride and P. J. Hall.

(b) On 6th May 1946 Tutors was incorporated to acquire and take over as a going concern the business of tutors carried on by Davies's. The share capital of Tutors was originally £4,000 divided into 3,890 5 per cent. cumulative preference shares of £1 each and 110 ordinary shares of £1 each.

At the material times the issued shares in Tutors were held as follows:

	Preference shares	*Ordinary shares*
M. R. Campbell	200	30
W. N. McBride	2,000	30
P. J. Hall	2,500	22
Mrs. Davies (widow of the founder)	500	20
Miss Harley	500	2
Mrs. Fairfax-Jones (wife of J. S. Fairfax-Jones)	500	2
Miss Goodman	500	2
	6,700	108

Messrs. Campbell, McBride and Hall were directors of Tutors, and Mr. J. S. Fairfax-Jones, a solicitor, was secretary to that company.

(*c*) By a declaration of trust made on 29th March 1961 (exhibit 3) by M. R. Campbell and J. S. Fairfax-Jones the Davies's Educational Trust was set up. The trustees of the Trust, M. R. Campbell and J. S. Fairfax-Jones, were required to hold the trust fund and the income thereof upon charitable trusts for the promotion and furtherance of education. The trustees had powers, *inter alia,* to accept donations, contributions and legacies; to issue appeals therefor; to purchase, acquire or found schools and tutorial establishments; to acquire buildings, land and chattels for the purpose of carrying on any school or tutorial establishment; and to provide bursaries, scholarships and prizes at schools or tutorial establishments.

The Trust was entered in the Register of Charities in accordance with the provisions of s. 4 of the Charities Act 1960, and was admitted to be a trust established for charitable purposes only within the meaning of s. 447(1)(*b*) of the Income Tax Act 1952.

(*d*) On the following day, namely, 30th March 1961, Tutors entered into a deed of covenant (exhibit 7) with the trustees of the Trust. Under this deed Tutors covenanted to pay annually on 5th April in every year for a period of seven years commencing on 5th April 1961 a sum equal to 80 per cent. of its net profits or gains chargeable to income tax under Case I of Schedule D, less any capital allowances properly allowable therefrom. The first payment under the deed was to be made on 5th April 1961. The figure of 80 per cent., and not 100 per cent., of the net profits was chosen because the payments to be made to the trustees would not be deductible in computing the profits of Tutors for profits tax purposes. The 20 per cent. of net profits was therefore retained to meet profits tax, and the trustees, in effect, were to get the whole of the net profits of Tutors after meeting profits tax.

(*e*) The directors of and the shareholders in Tutors had been aware for some time prior to the establishment of the Trust that it would be difficult, if not impossible, to find individuals who were both qualified to run Davies's and possessed of sufficient capital to purchase the organisation as a going concern. The directors and shareholders were anxious that Davies's should continue on an established and permanent basis, and they conceived the idea that a charitable trust should be set up to acquire Davies's. The Trust was set up for this purpose, and the deed of covenant of 30th March 1961 was entered into on the clear understanding by the directors and shareholders of Tutors and the trustees that the net sums payable thereunder, together with the income tax thereon (which it was thought would be recoverable under s. 447(1)(*b*)), would be used by the trustees to purchase the business of Davies's. There was no doubt in the minds of any of the parties that the trustees would use these moneys to acquire Davies's business.

Mr. C. A. Barber, who had acted as accountant to Vernon Davies and as auditor to Tutors, had the full confidence of all the parties concerned. It was left to him to work out the detailed implementation of the plan for the Trust to acquire the business of Tutors by means of the covenanted payments. The intention of all the parties to these arrangements was that the future of Davies's should be secured in the hands of an educational trust, and that the profits of Davies's should be used to obtain for the shareholders of Tutors a fair and reasonable price for their interests in that company.

(*f*) On 4th April 1962 Developments was incorporated to promote, carry on, further and encourage educational work of every description, with a share capital of £100 divided into 100 shares of £1 each. Two of the shares were issued, and are held one each by M. R. Campbell and Philip J. Hall respectively as trustees of the Trust.

The directors of Developments were the same as those of Tutors, namely, M. R. Campbell, W. N. McBride and P. J. Hall.

(*g*) By a deed dated 5th April 1962 (exhibit 6) Tutors and Developments entered into partnership for carrying on the business of Davies's hitherto carried on by Tutors.

Under the terms of the deed the goodwill of the business was agreed at £50,000. The deed provided that immediately after the execution thereof Developments "shall . . . purchase from Tutors one 1/5th share of the goodwill aforesaid at the price of £10,000 (Ten thousand pounds)". Developments "may in any subsequent year calculated from 6th April 1962 purchase from Tutors either the whole of the residue of the goodwill then vested in Tutors or shares or proportions thereof in units of £10,000 (Ten thousand pounds)". The deed further provided that, as from 6th April 1962, the profits of Davies's should be divided in accordance with the shares of the goodwill

owned by Tutors and Developments from time to time; and that the deed should remain in force for a period of ten years unless sooner determined by, *inter alia,* Developments acquiring the whole of the goodwill from Tutors. Provision was also made in the deed for the partnership to rent from Tutors the premises in which Davies's was carried on and the trade fixtures, fittings, furniture, books and equipment in those premises; and also for Developments to buy at a fair price the premises, fixtures, etc., in the event of the partnership being determined by Developments acquiring the whole of the goodwill of the business.

At some time after the execution of the partnership deed of 5th April 1962 it was discovered that the provisions thereof relating to trade fixtures, etc., would create difficulties in obtaining capital allowances for income tax purposes in respect of those trading fittings, etc. Accordingly the clause shown on the last page of exhibit 6 was added to the partnership deed.

On 31st March 1962 Mr. Barber informed the directors of Tutors that the value of the goodwill of Davies's, in his opinion, on the basis of a sale at arm's length between a willing seller and purchaser was not less than £50,000. This figure was adopted as the value of the goodwill for the purposes of the partnership deed (exhibit 6, clause 3(*c*)). In Mr. Barber's view the goodwill was worth between £50,000 and £57,000. Although it was improbable that a private individual or a group of private individuals could have been found with sufficient capital to purchase Davies's, it would have been possible to sell the business to an established large tutorial establishment.

The figure of £10,000 in clause 3(*e*) of the partnership deed (exhibit 6) was fixed by reference to the funds in the hands of the trustees.

(*h*) During the year ended 5th April 1963 the trustees of the Trust advanced £21,900 to Developments, which was used as to £10,000 to purchase a one-fifth share in the goodwill of Tutors in accordance with the terms of clause 3(*e*) of the partnership deed of 5th April 1962, and as to £11,900 to purchase the trade fixtures, etc., of Tutors.

It was admitted for the purpose of the hearing before us that the advance of £21,900 by the trustees to Developments was an application for the purposes of s. 447(1)(*b*) of the Income Tax Act 1952 of the income of the Trust for the two years ended 5th April 1962.

(*i*) Messrs. Campbell, McBride and Hall had had service agreements with Tutors for many years. These provided, *inter alia,* that in addition to salaries these three gentlemen should each have a share of the profits of Tutors. On the formation of the partnership between Tutors and Developments new service agreements were entered into, which provided for fixed salaries and no sharing of profits.

Up to 1962 Tutors had paid dividends of 800 per cent. on its ordinary shares as well as the preference dividends. Since then no dividends have been paid on the ordinary shares.

(*j*) The trustees of the Trust had intended to appoint additional trustees unconnected with the Davies's organisation, but had not thought it proper to do so while they were in dispute with the Inland Revenue about their title to repayment of income tax. The trustees regarded themselves as having the overall control of Davies's, to the extent of their ownership of the goodwill through Developments, and being responsible for the general policy of the business; the day-to-day control of the business being in the hands of the three directors.

The trustees' income for the period from 29th March 1961 to 5th April 1962 was £25,831 12*s.* 2*d.*, being the amounts receivable under the deed of covenant (exhibit 7) and totalling £25,527 4*s.*, together with bank deposit interest of £304 8*s.* 2*d.* A

6. It was contended on behalf of the Appellants that:

(*a*) the payments in question were annual payments forming part of the income of a trust established for charitable purposes only; B

(*b*) the said income was applied to charitable purposes only; and

(*c*) the Appellants were entitled to the exemption claimed.

7. It was contended on behalf of the Commissioners of Inland Revenue that:

(*a*) the disputed payments were not paid by Tutors without conditions or counter-stipulations and were not "pure income profit" in the hands of the Trust; C

(*b*) they were received by the Trust subject to an obligation, legal or practical, to use them for the benefit of Tutors;

(*c*) accordingly they are not "annual payments" within s. 447(1)(*b*) of the Income Tax Act 1952;

(*d*) they were not applied to charitable purposes only within s. 447(1)(*b*), being applied (*inter alia*) for the benefit of Tutors by securing the sale of assets and goodwill of its business; and D

(*e*) the exemption claimed had properly been refused.

8. We, the Commissioners who heard the appeal, took time to consider our decision, and gave it in writing on 1st December 1964 as follows:

(1) The first question for our decision is whether the payments made on 5th April 1961 and 5th April 1962 under the terms of the deed of covenant dated 30th March 1961 were annual payments within the meaning of s. 447(1)(*b*), Income Tax Act 1952. E

(2) This involves the question whether the payments were in the hands of the recipients pure income profit which flowed solely from the bounty of the payer, or, put another way, whether it can be said that the payer paid the sums covenanted without conditions or counter-stipulations. F

The fact that the Trust is recognised as a body established for charitable purposes only cannot, on authority, be conclusive of the issue in its favour, and it is necessary to look at the facts of the case and at their substance and reality.

(3) The evidence adduced before us established quite clearly that, when Tutors entered into the deed of covenant on 30th March 1961, an understanding had been reached between the three directors of (and main sharholders in) Tutors, the rest of the shareholders in Tutors and the trustees of the Trust (who were a director of and secretary to Tutors) that the covenanted payments would be used by the trustees to buy the business of Tutors as a going concern. The intention of all these parties was that Davies's, in its present form, should be perpetuated in the hands of an educational trust and that the equity shareholders of Tutors should in due course receive a fair but not excessive price for the assets of Tutors. G H

The implementation of these intentions was left to Mr. Barber, who had the full confidence of all the parties.

(4) In these circumstances the issue narrows down to the question whether this understanding as to the use of the covenanted payments by the Trustees imposed an obligation on them which amounted to a condition I

or counter-stipulation. The form which the actual arrangements took to implement this understanding seems to us irrelevant in considering this matter, except in so far as it confirms the understanding and demonstrates that the use of the covenanted payments was an essential part of the fulfilment of the intentions of all the parties. The precise terms of the partnership deed of 5th April 1962 as to the acquisition of the goodwill and other assets of Tutors cannot be taken as definitive of the understanding between all the parties when the deed of covenant was signed, just over a year earlier, on 30th March 1961, because, on the evidence of Mr. Barber, the precise terms for working out the common purpose of the parties were left open.

(5) We find that, while the arrangements to be made for the gradual transfer of the business of Davies's from Tutors to the Trust were to give no advantage to Tutors or its shareholders in the sense that they were to get an advantageous price for the business, the arrangements did have as their main objects that Davies's would continue in its existing form and that a not unreasonable price would be paid for its assets. These two objects were desired by Tutors and all its shareholders and were to that extent advantages or benefits to them.

We also find that the deed of covenant was an essential part of these arrangements. It was entered into on a clear understanding by both Tutors and its shareholders on the one side and by the trustees on the other that the payments thereunder would be used to buy Tutors' business.

(6) This understanding that the covenanted payments would be so used seems to us, and we so hold, to be a condition or counter-stipulation attached to the deed of covenant. We look upon it as more analogous to the condition on the part of the National Book League against which the covenants in that case were entered into rather than to those incidental privileges which might be enjoyed by a donor to a charity which were referred to by Lord Evershed M.R. in *Commissioners of Inland Revenue* v. *National Book League*[1] 37 T.C. 455, at pages 469–70. We are concerned here, not with covenanted payments to a nationally known charitable institution, but with payments which formed virtually the whole income of this charitable Trust, which was set up to acquire the assets of the covenantor by means of those payments in such circumstances that we feel bound, although sympathising with the motives of the parties, to hold that the disputed payments are not annual payments.

(7) In view of this decision the second question argued before us, namely, whether the income of the Trust was applied for charitable purposes only, does not arise. If we are wrong on this first point and the disputed payments are truly annual payments, we do not think it can be said that they were not applied for charitable purposes only merely because they were applied for a purpose admittedly charitable, namely, the acquisition of part of the assets of a school, in pursuance of an understanding with the donor that they would be so applied.

(8) We dismiss the appeal.

9. The Appellants, immediately after the determination of the appeal, declared to us their dissatisfaction therewith as being erroneous in point of law, and on 9th December 1964 required us to state a Case for the opinion of the High Court pursuant to the Income Tax Act 1952, s. 64, which Case

(1) [1957] Ch. 488.

we have stated and do sign accordingly. The question of law for the opinion of the Court is whether the Appellants are entitled to the exemption claimed. A

W. E. Bradley
B. James
} Commissioners for the Special Purposes of the Income Tax Acts.

Turnstile House,
94–99 High Holborn,
London, W.C.1.
3rd September, 1965. B

The case came before Buckley J. in the Chancery Division on 23rd, 24th and 25th March 1966, when judgment was reserved. On 6th April 1966 judgment was given in favour of the Crown, with costs. C

Desmond Miller Q.C. and *Sidney Simon* for the Appellants.

E. I. Goulding Q.C., J. Raymond Phillips and *J. P. Warner* for the Crown.

The following cases were cited in argument in addition to those referred to in the judgment:—*Commissioners of Inland Revenue* v. *Wesleyan & General Assurance Society* (1948) 30 T.C. 11; *Taw and Torridge Festival Society Ltd.* v. *Commissioners of Inland Revenue* (1959) 38 T.C. 603; *Escoigne Properties Ltd.* v. *Commissioners of Inland Revenue* [1958] A.C. 549; *Edwards* v. *Skyways Ltd.* [1964] 1 W.L.R. 349; *Vestey* v. *Commissioners of Inland Revenue* 40 T.C. 112; [1962] Ch. 861; *J. P. Harrison (Watford) Ltd.* v. *Griffiths* 40 T.C. 281; [1963] A.C. 1; *Commissioners of Inland Revenue* v. *Frere* 42 T.C. 125; [1965] A.C. 402. D

E

Buckley J.—On 6th May 1946 a company was incorporated by the name of Davies's (Tutors) Ltd. for the purpose of acquiring as a going concern the well-known tutorial business of Davies's, which had been founded by Mr. Vernon Davies in the year 1927. That company at the material time had seven shareholders only, of whom three, Mr. Campbell, Mr. McBride and Mr. Hall, were the majority shareholders, and they were the three directors of that company, which I will refer to as "Tutors". The secretary of the company was Mr. Fairfax-Jones. F

The directors and shareholders of Tutors were anxious that the business, Davies's, should continue on an established and permanent basis. They were aware that it would be difficult, if not impossible, to find individuals who were both qualified to run the business and possessed of sufficient capital to purchase it as a going concern, and they conceived the idea that a charitable trust should be set up to acquire the business. G

On 29th March 1961 Mr. Campbell, a director of the company, and Mr. Fairfax-Jones, the secretary, executed a declaration of trust the purpose of which was to establish an educational trust to be known as "The Davies's Educational Trust", of which they would be the first trustees. The declaration of trust declared that H

> "'the Trust Fund' shall mean and include all moneys and other property which may hereafter from time to time be received accepted or held by the Trustees on the trusts"

of the declaration of trust. Clause 3 of the deed provided that the trustees should hold the trust fund and the income thereof upon charitable trusts for I

A the promotion and furtherance of education, and that the subsequent provisions of the deed should take effect subject to and only so far as ancillary to, consistent with and in furtherance of that primary charitable trust. It was expressly provided in the declaration of trust that the trustees should have power, *inter alia,* to purchase or otherwise acquire or found and to carry on schools and tutorial establishments, and to purchase, take on lease, hire, B acquire by gift or on loan or otherwise acquire any buildings and lands and chattels for the carrying on of any school or tutorial establishment and to use the same accordingly.

On the following day, 30th March 1961, Tutors executed a deed of covenant, to which Tutors were the parties of the first part, and Mr. Campbell and Mr. Fairfax-Jones as trustees of the declaration of trust were the parties C of the other part, whereby Tutors covenanted with the trustees that it would out of the general fund of taxed income of Tutors annually on 5th April in every year for seven years commencing on 5th April 1961 pay to the trustees to hold upon the trusts of the declaration of the trust such a sum as would amount to 80 per cent. of the profits or gains accruing to the company from any trade carried on by the company in the accounting year immediately D preceding such 5th April. The figure of 80 per cent. of the net profits was chosen because the payments to be made to the trustees would not be deductible in computing the profits of Tutors for profits tax purposes. The 20 per cent. of net profits was therefore retained to meet profits tax, and the trustees in effect were to get the whole of the net profits of Tutors after meeting profits tax.

E The declaration of trust and the deed of covenant were entered into, as the Commissioners found, on the clear understanding by the directors and shareholders of Tutors and the trustees that the net sums payable under the deed of covenant, together with the income tax thereon which it was thought would be recoverable under s. 447(1) (*b*) of the Income Tax Act 1952, would be used by the trustees to purchase the business of Davies's. There was no doubt, F the Commissioners found, in the minds of any of the parties that the trustees would use these moneys to acquire Davies's business. Mr. Barber, who had acted as accountant to Mr. Vernon Davies and as auditor to Tutors, had the full confidence of all the parties concerned, and it was left to him to work out the detailed implementation of the plan for the Trust to acquire the business of Tutors by means of the covenanted payments. The intention of all the G parties, the Commissioners found, to these arrangements was that the future of Davies's should be secured in the hands of an educational trust and that the profits of Davies's should be used to obtain for the shareholders of Tutors a fair and reasonable price for their interests in that company.

The next stage in the working out of this scheme was not reached until 4th April 1962, when a company by the name of Davies's Educational Develop- H ments Ltd. was incorporated. I will refer to that company as "Developments". Developments was incorporated to promote, carry on, further and encourage educational work of every description. Its authorised share capital was £100 divided into 100 shares of £1 each, but only two shares were issued, one to Mr. Campbell and the other to Mr. Hall. Both those shares were held by the registered holders on behalf of the trustees of the Trust. The directors of I Developments were Mr. Campbell, Mr. McBride and Mr. Hall, the three gentlemen who were directors of Tutors.

On the following day, 5th April 1962, Tutors entered into a partnership with Developments. Under the terms of the deed of partnership the value of the goodwill of the business, Davies's, was agreed at £50,000. The partnership deed provided that immediately after the execution thereof Developments

(Buckley J.)

should purchase from Tutors a one-fifth share of the goodwill of Davies's at a price of £10,000. The deed further provided that Developments

> "may in any subsequent year calculated from 6th April 1962 purchase from Tutors either the whole of the residue of the goodwill then vested in Tutors or shares or proportions thereof in units of £10,000."

It further provided that, as from 6th April 1962, the profits of Davies's should be divided in accordance with the shares or proportions of the goodwill owned by Tutors and Developments from time to time, and that the deed should remain in force for a period of ten years unless sooner determined by, *inter alia*, Developments acquiring the whole of the goodwill from Tutors. Provision was made in the deed for the partnership to rent from Tutors the premises upon which Davies's was carried on, and the trade fixtures, fittings, furniture, books and equipment in those premises, and also for Developments to buy at a fair price the premises, fixtures, etc., in the event of the partnership being determined by Developments acquiring the whole of the goodwill of the business.

After the execution of the partnership deed it was discovered that the provisions of that deed relating to trade fixtures and so forth would create difficulties in obtaining capital allowances for income tax purposes in respect of those fittings, and accordingly a supplemental term of the partnership was agreed in the following terms:

> "Notwithstanding anything contained in Clauses (h) (i) or elsewhere in the within Agreement"—that is, the partnership agreement—"it is agreed that the Partnership will purchase from Davies's (Tutors) Limited the trade fixtures fittings furniture books and equipment in or about the respective premises specified in the Schedule to the within agreement at a price to be certified by Messrs. Barber & Company . . . as at 6th April 1962 but Davies's (Tutors) Limited will leave the whole of the purchase price so certified as a loan to the Partnership for the duration of the Partnership such price to be paid by the Partners or their successors to the business of Davies's within 28 days of the termination of the Partnership from whatever cause".

Then there is a provision for interest to be paid on the loan and a proviso that the partnership might at any time make payments on account of or in settlement of the said purchase price and in that case the said share of the profits should be abated *pro rata*.

On 31st March 1962—that is, before the partnership deed was entered into—Mr. Barber had informed the directors of Tutors that the value of the goodwill of Davies's in his opinion, on the basis of a sale at arm's length between a willing seller and purchaser, was not less than £50,000. That figure was adopted as the value of the goodwill for the purposes of the partnership deed accordingly. Mr. Barber's view was that the goodwill was worth between £50,000 and £57,000. Although it was improbable that a private individual or a group of private individuals could have been found with sufficient capital to purchase Davies's, it would have been possible to sell the business to an established large tutorial establishment.

On 5th April 1961 and 5th April 1962 Tutors became indebted under the deed of covenant to the trustees in sums aggregating £25,527, and that amount was paid by Tutors to the trustees subject to deduction of tax at the standard rate. On 5th April 1963 Tutors became indebted to the trustees under the deed of covenant in a further sum of £10,456, which was also paid by Tutors to the trustees subject to deduction of tax at the standard rate. The net amounts so received by the trustees amounted in the aggregate to something in excess of

A £21,900. During the year ended 5th April 1963 the trustees of the Trust advanced a sum of £21,900 to Developments, which Developments used as to £10,000 to purchase a one-fifth share in the goodwill of Tutors in accordance with the terms of the partnership deed, and as to £11,900 to purchase the trade fixtures and so forth of Tutors in accordance with the added term of the partnership deed. It was admitted for the purposes of the hearing before the B Commissioners that that advance of £21,900 by the trustees to Developments was an application for the purpose of s. 447(1)(*b*) of the Income Tax Act 1952 of the income of the Trust for the two years ended 5th April 1962. Developments have been treated throughout, both before the Commissioners and in this Court, as an emanation of the trustees and as no more than the machinery by which the trustees were to acquire the business of Davies's and C carry it on. Accordingly, no point is taken upon the separate existence of Developments as distinct from the trustees. Messrs. Campbell, McBride and Hall had had service agreements with Tutors for many years. These provided, *inter alia,* that in addition to salaries these three gentlemen should each have a share of the profits of Tutors. On the formation of the partnership between Tutors and Developments new service agreements were entered into which D provided for fixed salaries and no sharing of profits. Up to 1962 Tutors had paid dividends of 800 per cent. on its ordinary shares as well as the preference dividends. Since then no dividends have been paid on the ordinary shares. That, of course, is because the profits of Tutors have been applied in accordance with the provisions of the deed of covenant. The trustees claimed exemption from income tax chargeable for the years 1960–61 and 1961–62 on the E payments so received by them under the deed of covenant under s. 447(1)(*b*) of the Act. The Commissioners of Inland Revenue rejected these claims. The trustees appealed to the Special Commissioners, who dismissed the appeal, and the trustees now appeal to this Court.

The relevant sections of the Statutes are these. The charge to tax under Schedule D is to be found in ss. 122 and 123 of the Income Tax Act 1952, and F the relevant Case for the present purpose is Case III, under which tax is charged in respect of any interest of money, whether yearly or otherwise, or any annuity or other annual payment. Section 169 provides:

> "Where any yearly interest of money, annuity or other annual payment is payable wholly out of profits or gains brought into charge to tax"

no assessment, putting it shortly, shall be made upon the recipient but the whole G shall be assessed upon the person liable to make the payment, and the person liable to make the payment is authorised on making that payment to deduct and retain out of it a sum representing the amount of tax upon it at the standard rate for the year in which the payment becomes due. Section 447(1)(*b*) provides as follows:

> "Exemption shall be granted . . . from tax chargeable . . . under H Schedule D in respect of any yearly interest or other annual payment, forming part of the income of any body of persons or trust established for charitable purposes only . . . and so far as the same are applied to charitable purposes only".

The right of Tutors to deduct tax from payments under the deed of covenant depends on those payments being "annual payments" within the meaning of I s. 169. If they are not such annual payments Tutors are liable to make them without deduction, and there will be no occasion for any claim to exemption by the trustees under s. 447(1)(*b*). If, on the other hand, they are such annual payments, the trustees can claim exemption from income tax if, and only if and to the extent that, the amounts received by them from Tutors under the deed of

(Buckley J.)

covenant have been applied to charitable purposes only. It is conceded that the trustees are trustees of a trust established for charitable purposes only. A

I will consider first whether the payments made by Tutors under the deed of covenant are annual payments within the meaning of s. 169. The Act contains no definition of the meaning of "annual payment", but there is some judicial authority upon the interpretation of this expression. The conundrum "When is an annual payment not an annual payment?" admits of several answers: when it is an instalment of a capital sum (*Commissioners of Inland Revenue* v. *Ramsay* (1935) 20 T.C. 79); when it is a trading receipt of the recipient against which outgoings of his trade must be taken into account in order to discover the amount of his taxable profits (*Earl Howe* v. *Commissioners of Inland Revenue* [1] 7 T.C. 289, *per* Scrutton L.J., at page 303; *Commissioners of Inland Revenue* v. *Corporation of London* (*as Conservators of Epping Forest*) [2] 34 T.C. 293, *per* Lord Normand, at page 320, and Lord Reid, at pages 326–7); when it is a payment made to a trading company to supplement its trading receipts (*British Commonwealth International Newsfilm Agency Ltd.* v. *Mahany* [3] 40 T.C. 550); when it is a subscription to a charitable body as a consequence of which the subscriber enjoys certain privileges or amenities provided for subscribers by that body (*Commissioners of Inland Revenue* v. *National Book League* [4] 37 T.C. 455). This catalogue is no doubt not exhaustive. B C D

In re *Hanbury* (1939) 38 T.C. 588, Sir Wilfred Greene M.R. stated the matter this way, at page 590:

> "There are two classes of annual payments which fall to be considered for Income Tax purposes. There is, first of all, that class of annual payment which the Acts regard and treat as being pure income profit of the recipient undiminished by any deduction. Payments of interest, payments of annuities, to take the ordinary simple case, are payments which are regarded as part of the income of the recipient, and the payer is entitled in estimating his total income to treat those payments as payments which go out of his income altogether. The class of annual payment which falls within that category is quite a limited one. In the other class there stand a number of payments, none the less annual, the very quality and nature of which make it impossible to treat them as part of the pure profit income of the recipient, the proper way of treating them being to treat them as an element to be taken into account in discovering what the profits of the recipient are. This matter was dealt with in a very well-known passage in the judgment of Scrutton, L.J., in *Earl Howe* v. *Commissioners of Inland Revenue*[5], which, if I may say so, I have always found particularly illuminating on questions of this kind. The type of example he gives is that of a yearly payment made, for instance, to the proprietor of a garage for the hire of a motor car. Nobody would suggest that on making that payment the hirer would be entitled to deduct tax, and yet it is an annual payment, the reason being that the very nature of that payment itself, having regard to the circumstances in which it is made, necessarily makes the sums paid in the hands of a recipient an element only in the ascertainment of his profits." E F G H

To the question "When *is* an annual payment an annual payment?" in the sense in which the term is used in these sections of the Income Tax Act 1952 the authorities suggest three possible answers: when it is *ejusdem generis* I

(1) [1919] 2 K.B. 336. (2) [1953] 1 W.L.R. 652. (3) [1963] 1 W.L.R. 69.
(4) [1957] Ch. 488. (5) 7 T.C. 289, at p. 303.

with interest of money and annuities (*Earl Howe* v. *Commissioners of Inland Revenue* 7 T.C. 289, *per* Scrutton L.J., at page 303; *Commissioners of Inland Revenue* v. *Whitworth Park Coal Co. Ltd.* 38 T.C. 531, at page 548); when the payment is such as to have the character of taxable income of the recipient (*Earl Howe* v. *Commissioners of Inland Revenue, per* Warrington L.J., at pages 299–300, and Scrutton L.J., at page 303; *Duke of Westminster* v. *Commissioners of Inland Revenue* 19 T.C. 490, *per* Lord Tomlin, at page 518); when it is "pure income profit" or "pure profit income" of the recipient (In re *Hanbury* 38 T.C. 588, *per* Sir Wilfrid Greene M.R., in the passage cited). The last two answers may be no more than different ways of saying the same thing. The payment cannot attract income tax unless it can properly be described as income. The payment as a whole cannot be income if any outgoing has to be taken into account against it to discover how much of the payment is profit; that is to say, it cannot as a whole be income unless as a whole it is clear profit to the recipient. It must not only be income in the recipient's hands: it must all be income in his hands. This was, I think, what Lord Normand had in mind when in *Commissioners of Inland Revenue* v. *Corporation of London* (*as Conservators of Epping Forest*) 34 T.C. 293, at page 320, he said that Sir Wilfrid Greene M.R.'s formula would perhaps lose nothing by the omission of the words "pure profit".

That the payments made and to be made by Tutors under the deed of covenant are annual payments in the literal sense of that term cannot be denied. The Appellants claim that they should properly be described as income of their trust, and that they are consequently properly paid by Tutors subject to deduction of tax under s. 169 as "annual payments" within the meaning of that section and that they are also "annual payments" within the meaning of s. 447(1)(*b*). The Crown contends that the payments are not "annual payments" within s. 169 or s. 447 because, as Mr. Goulding says, they are not pure bounty.

In *Commissioners of Inland Revenue* v. *Corporation of London* (*as Conservators of Epping Forest*) the question arose whether payments made by the Corporation of London under the Epping Forest Act 1878 to the Corporation itself, but in its other capacity as the Conservators of Epping Forest, were annual payments within Case III of Schedule D. It was accepted that the Corporation as Conservators was a separate legal person from the Corporation in its normal capacity, and that the Conservators were a body established for charitable purposes only. By the Act the Corporation was required to contribute to the income of the Conservators to make up any deficiency in their income to meet their outgoings. These contributions by the Corporation were made annually and wholly out of profits or gains on which the Corporation had paid tax. The case turned upon whether the payments were income in the hands of the Conservators. The Crown contended that the payments were made in return for services or advantages to the Corporation. This contention was rejected by the House of Lords, as also was the suggestion that the payments had the character of trade receipts. At page 324, Lord Normand said:

> "The sum, in my opinion, is in no different position from a sum (having the requisite quality of recurrence) paid without conditions or counter stipulations out of taxed income under a covenant by a private individual to any charitable body."

At page 327, Lord Reid said:

> "But in my judgment the payments in this case are not trading receipts in the hands of the Conservators even if they are carrying on a trade or something in the nature of a trade. Trading receipts are generally received in return for something done or provided by the recipient for the payer, but, as I have said, that does not appear to me to be the case

(Buckley J.)

here. So if the Appellants are to succeed it must be because the payments in this case fall within some other class of annual payments which, as well as annual payments received as trading receipts in return for something done or provided or to be done or provided, must for some reason be held to be excepted from the scope of Case III. But before considering this difficult question I think it well to consider certain annual payments, not related to any benefit to the payer, which in my opinion are clearly within the scope of Case III. That most relevant to the present case is an annual subscription under covenant to a charity by a donor who gets no advantage to himself in return for it."

The sum there in question, being one of the annual payments made by the Corporation under the Act, was held to have been properly treated as an "annual payment" within the statutory provisions then in force and now replaced by ss. 123(1), Case III, 169 and 447 (1)(*b*).

On the other hand, in *Commissioners of Inland Revenue* v. *National Book League*(1), covenanted payments by contributors to the National Book League, a charitable body, were held not to come within Case III because their payment was not free from conditions or counter-stipulations. The League offered certain privileges and amenities to its contributors or members. Until December 1951 the minimum annual subscription payable by individual members was one guinea for London members and half a guinea for country members. It was then resolved to increase these subscriptions to £1 10*s*. and 15*s*. respectively, except in the case of members who should covenant to remain members at the existing rates for at least seven years. In a circular letter the chairman, urging members to execute covenants, mentioned that the incidental benefits of membership were considerable. Under the rules of the League the managing committee could have discontinued any of the members' privileges or amenities at any time, but members who executed covenants were clearly entitled to remain members during the currency of their covenants at the existing rate of subscription and, as members, to enjoy such privileges and amenities as the committee of management elected to make available to members from time to time. Upon these facts Lord Evershed M.R. said, at page 473:

"The question, therefore, as I see it, turns first upon this: looking at the substance and reality of the matter, can it be said that those who entered into these covenants have paid the sums covenanted without conditions or counter stipulations? On the whole I have come to the conclusion that they cannot so say."

At page 474, he went on:

"If the test be, as I venture to think it is, whether in all the circumstances, and looking once more at the substance and reality of the matter, these covenantors can be treated as donors of the covenanted sums to the charity, I have come to the conclusion that the answer must be in the negative, subject to the point to which I will now come as to the extent of the conditions or counter stipulations."

His Lordship went on to hold that the benefits conferred by the conditions or counter-stipulations could not be disregarded on the principle that *de minimis non curat lex*. Morris L.J., at page 475, said:

" The question arises whether the payments can be said to be pure gifts to the charity. In the terms of a phrase which has been used, can the payments be said to be pure income profit in the hands of the charity ? If the payments were made in such circumstances that the League was

(1) 37 T.C. 455.

A obliged to afford to the covenantors such amenities and such benefits of membership as would at any particular time be offered to all members, and if those amenities and benefits were appreciable and not negligible, then I do not think that the payments were pure income profit in the hands of the charity"

and went on to decide that the payments were so made and that the benefits B were not negligible. This decision, I think, clearly proceeded upon the view that the covenanted subscriptions were not "annual payments" in the technical sense because they were not clear profit to the National Book League. The observations of Lord Normand and Lord Reid in the *Epping Forest* case(1), which I have read, show, I think, that they had the same consideration in mind. Payments to a charitable body upon terms that the payer shall receive something C in return are in fact analogous to payments to a tradesman in consideration of his supplying goods or services. They are not pure profit to the recipient but only a factor in calculating the recipient's profit.

Basing his argument mainly upon *Commissioners of Inland Revenue* v. *National Book League*(2), Mr. Goulding contends that the payments made by Tutors under the deed of covenant were not annual payments in the technical D sense because they were not pure bounty on account of the fact, as he submits, that the trustees of the Trust are obliged to apply all sums so received by them towards buying the business of Davies's from Tutors. Mr. Miller, on the other hand, for the Appellants, contends that the trustees were in fact under no binding obligation in this respect, and further that to come within the principle of *Commissioners of Inland Revenue* v. *National Book League* the condition E subject to which payment is made must be for a continuing consideration involving the recipient in expenditure on the supply of goods or services.

I have already read from the Case Stated the Commissioners' finding of fact about the understanding upon which the deed of covenant was entered into and their finding about the intention of all parties that the profits of Davies's (that is to say, as I read the Case, that part of them paid to the trustees under F the deed of covenant) should be used to obtain for the shareholders of Tutors a fair and reasonable price for their interests in that company. In this connection the Commissioners found as follows:

"The evidence adduced before us established quite clearly that, when Tutors entered into the deed of covenant on 30th March 1961, an understanding had been reached between the three directors of (and main G shareholders in) Tutors, the rest of the shareholders in Tutors and the trustees of the Trust (who were a director of and secretary to Tutors) that the covenanted payments would be used by the trustees to buy the business of Tutors as a going concern. The intention of all these parties was that Davies's, in its present form, should be perpetuated in the hands of an educational trust and that the equity shareholders of Tutors should in H due course receive a fair but not excessive price for the assets of Tutors. The implementation of these intentions was left to Mr. Barber, who had the full confidence of all the parties."

In my judgment, in the light of these findings the Commissioners were fully justified in holding further, as they did, that this use of the covenanted payments was an essential part of the fulfilment of the intentions of all the parties I and that the deed of covenant was entered into on the clear understanding by both Tutors and its shareholders on the one hand and by the trustees on the other that the payments thereunder would be used to buy Tutors' business.

(1) 34 T.C. 293, at pp. 324 and 327. (2) 37 T.C. 455.

(Buckley J.)

In these circumstances the trustees, in my judgment, upon the execution of the deed of covenant, became contractually bound to Tutors to apply all sums received by them under the covenant towards the purchase of the business of Davies's as a going concern, such obligation arising upon a collateral contract by conduct. If the trustees were not so bound contractually, I think that the trustees must be regarded as receiving each payment under the deed subject to an earmark by Tutors for its application exclusively towards purchase of the business so as to clothe each payment with a trust for that purpose. Accordingly I reject the Appellants' submission that the trustees were under no legally binding obligation in this respect.

The Commissioners, treating this understanding that the covenanted payments would be so used as a condition or counter-stipulation analogous to those considered in *Commissioners of Inland Revenue* v. *National Book League*(1), held that they were not "annual payments" in the relevant sense. The obligation to apply the payments in the purchase of the business extends to the whole of each payment and differs in that respect from the provision of privileges and amenities as in *Commissioners of Inland Revenue* v. *National Book League,* the cost of which would have been merely a factor in discovering how far the contributions of members to the League constituted clear profit in its hands. Not every condition or stipulation attached to a series of periodical payments to a charity will, I think, be such as to deprive those payments of the character of "annual payments" in the special sense. For instance, if a charity were to conduct two schools, one for boys and one for girls, out of a common fund, and an annual contributor were to stipulate that his contributions should be used exclusively for the girls' school, this would not, as it seems to me, be such a stipulation as to deprive his contributions of the character of annual payments in that sense. A condition or stipulation to have that effect must, I think, be such as to deprive the periodical payments, and the whole of each of those payments, of the character of income in the recipient charity's hands.

The fact that the trustees are bound to repay every covenanted sum to Tutors in the form of purchase money does not seem to me essentially to deprive the covenanted payments of the character of bounty. They are at least steps in a process of pure bounty. If any question of recovery of tax by the trustees be for a moment put aside, the substance of the arrangement is that Tutors makes gratuitous transfers to the trustees of shares in the business at a rate geared to the proportion which 80 per cent. of Tutors' profits from the business bears to £50,000, the value put upon the goodwill, and the cost of any other assets. The payments under the deed merely pass from Tutors to the trustees and back again as machinery for determining how quickly and by what stages the business shall be transferred. The business costs the trustees nothing. They acquire the business as a pure act of bounty from Tutors. Nor, again ignoring the possibility of the trustees recovering any tax, does Tutors secure any advantage from the payments apart from the implementation of its desire to effect a voluntary transfer of the business by stages to the trustees. If the trustees are in fact entitled to recover tax and use any amounts recovered as well as the covenanted payments to pay the agreed purchase price, this will speed the transfer. It will not result in Tutors receiving any larger price than otherwise but will result in their receiving the whole amount more quickly. This would benefit the Trust, which would the more rapidly become entitled to a larger interest in, and ultimately the whole of, the business, and would also to some extent benefit Tutors by making cash available for distribution amongst its members more rapidly. None of this would be at the expense of the Trust or make the covenanted payments to the trustees any the less pure

(1) 37 T.C. 455.

A profit or bounty.

I feel difficulty, therefore, in accepting Mr. Goulding's submission that the covenanted payments are not annual payments in the technical sense because they are not pure bounty. Nevertheless they are not, in my judgment, annual payments within the meaning of the sections to which I have referred, because they are not, in my judgment, income in the hands of the trustees. Each B payment is received by the trustees committed to its being applied in its entirety to the purchase of a capital asset which, as the Case Stated makes clear, it was the intention of all parties that the trustees should retain and maintain as a going concern. Indeed the preservation of the business was the basic objective of the whole transaction. The covenanted payments, if, as I am prepared to assume, they ought to be regarded as belonging to the trustees in a real sense C at all, were, in my judgment, contributions or accretions to the capital stock or endowment of the trust and were just as truly receipts on capital account and not on account of income as instalments of the proceeds of sale of a capital asset would be. As such they were not, in my opinion, *ejusdem generis* with interest on money and annuities belonging to the trustees. I do not forget that in the *Epping Forest* case[1], at page 324, Lord Normand said that you cannot D determine the nature of a payment by enquiring what becomes of it, or even what must become of it after the payee has received it, but his Lordship was not there saying, as I understand him, that one should disregard the nature of the receipt in the recipient's hands.

I do not think that the admission recorded in para. 5(*h*) of the Case, which I have read[2], precludes me from deciding the case upon the ground that the E covenanted payments are not income in the hands of the trustees. What the Crown admitted, as I read this paragraph, was that the advance of £21,900 by the trustees to Developments was an "application" of that amount for the purposes of s. 447(1)(*b*). Having regard to the Crown's contentions as also recorded in the Case the Crown cannot, I think, be understood to have admitted that the covenanted payments were income of the Trust. Accordingly, I reach F the conclusion that the covenanted payments, not being income in the trustees' hands, are not annual payments within the special meaning to be attributed to that expression as used in ss. 169 and 447 of the Income Tax Act 1952.

If I am wrong in this view, it is necessary to consider whether the Trust was established for charitable purposes only and whether the sum of £21,900 has been applied for charitable purposes only. That the Trust was established G for charitable purposes only is admitted. Nevertheless it is said that the expenditure of the £21,900, as to £10,000 towards paying the purchase price of the goodwill of Davies's and as to the balance in paying the price of fixtures and so forth used in connection with the business, was made for a dual purpose, that is to say, first, in pursuance of the charitable trusts declared by the declaration of trust, and, secondly, in pursuance of the obligation of the H trustees to Tutors to use the money in this manner. It is, of course, the character of the application of the moneys by the trustees that must be considered in this connection and not the character or motive of the payment by Tutors to the trustees. The purchase of schools and tutorial establishments is a form of expenditure expressly authorised by the declaration of trust so far as ancillary to, consistent with and in furtherance of the primary charitable purpose of I promoting education. The purchase by the trustees of the business of Davies's is charitable. The whole of the £21,900 has been applied for that charitable purpose. There is no suggestion that this involved any impropriety on the part of the trustees as trustees of a charitable trust. The whole amount has been

(1) 34 T.C. 293. (2) *See* page 437 *ante*.

(Buckley J.)

applied, and properly applied, to charitable purposes. It is not, in my judgment, necessary or permissible to consider what reason or motive the trustees may have had for their method of applying the money, or whether they were under any obligation to adopt that method, or whether it may have conferred some incidental benefit on someone else—in this case, upon Tutors: see in this connection *Barclays Bank Ltd.* v. *Naylor*(1) 39 T.C. 257. The requirements of s. 447(1)(*b*) are, in my judgment, satisfied so soon as it is shown that the body claiming relief from tax is established for charitable purposes only and that the sum in respect of which relief is claimed has been wholly applied to charitable purposes. In the present case the first of these matters is conceded and the second is established. Accordingly, had I reached a different conclusion on the first question I should have allowed this appeal, but on account of my conclusion on the first question I must dismiss it.

Warner—I ask for dismissal of the appeal with costs.

Buckley J.—That must follow, Mr. Miller?

Miller Q.C.—My Lord, there were two points, as it happened, arising in this Court. Substantially, after having heard Mr. Goulding, on one of these points I would have submitted that I had succeeded.

Buckley J.—Well, you have not succeeded in the result.

Miller Q.C.—In the result no, my Lord.

Buckley J.—No, I think it is right that the appeal should be dismissed with costs.

The trustees having appealed against the above decision, the case came before the Court of Appeal (Lord Denning M.R. and Harman and Salmon L.JJ.) on 8th, 9th and 10th February 1967, when judgment was reserved. On 13th February 1967 judgment was given unanimously in favour of the Crown, with costs.

Desmond Miller Q.C., Sidney Simon and *Mrs. Margot Hoare* for the Appellants.

E. I. Goulding Q.C., J. Raymond Phillips and *J. P. Warner* for the Crown.

The following cases were cited in argument in addition to those referred to in the judgments:—*Edwards* v. *Bairstow* 36 T.C. 207; [1956] A.C. 14; *Hutchinson & Co. (Publishers) Ltd.* v. *Turner* (1950) 31 T.C. 495; *Morley* v. *Tattersall* (1938) 22 T.C. 51; *Commissioners of Inland Revenue* v. *Forth Conservancy Board* 16 T.C. 103; [1931] A.C. 540; *Barclays Bank Ltd.* v. *Naylor* 39 T.C. 256; [1961] Ch. 7; *Commissioners of Inland Revenue* v. *Frere* 42 T.C. 125; [1965] A.C. 402; *Commissioners of Inland Revenue* v. *Ramsay* (1935) 20 T.C. 79; *Commissioners of Inland Revenue* v. *Wesleyan and General Assurance Society* (1948) 30 T.C. 11; *British Commonwealth International Newsfilm Agency Ltd.* v. *Mahany* 40 T.C. 550; [1963] 1 W.L.R. 69; *Edwards* v. *Skyways Ltd.* [1964] 1 W.L.R. 349; *Escoigne Properties Ltd.* v. *Commissioners of Inland Revenue* [1958] A.C. 549.

Lord Denning M.R.—"Davies's" is a first class place of education. It was founded by Mr. Vernon Davies in 1927 and turned into a private limited

(1) [1961] Ch. 7.

company in 1946, called Davies's (Tutors) Ltd. The founder died unexpectedly in 1952, leaving his interest to his widow. Since that time Davies's has been run by three of the principals, Mr. Campbell, Mr. McBride and Mr. Hall. They are directors of Davies's (Tutors) Ltd., and, together with Mrs. Davies, hold most of the shares. In 1961 they were all anxious to establish Davies's on a permanent basis. So they decided to set up a charitable trust for the purpose. The idea was that the trust should buy from Davies's (Tutors) Ltd. the goodwill, premises and equipment of Davies's and then carry it on for the years to come. They consulted their solicitor, Mr. Fairfax-Jones, and their accountant, Mr. C. A. Barber, and under their advice executed various documents to implement the plan. One of these documents was a seven-year covenant in favour of the charitable trust. The object was to enable the trust to recover tax on the payments under the covenant. That is a perfectly legitimate thing to seek to do. Every charity in the country benefits in this way by seven-year covenants. The question is whether it has succeeded in this case.

The facts are given in the Stated Case. Suffice it for me to reduce them to the essentials. (1) *The charitable trust for education.* On 29th March 1961 a charitable trust was formed under the name "The Davies's Educational Trust". The first trustees were Mr. Campbell (a director and shareholder in Davies's (Tutors) Ltd.) and Mr. Fairfax-Jones (a solicitor and the secretary of Davies's (Tutors) Ltd.) There was to be a trust fund of moneys thereafter to be received by the trustees, and the trustees were to hold the fund upon charitable trusts for the promotion of education, with power (amongst other things) to purchase, acquire and carry on schools and tutorial establishments. (2) *The seven-year covenant.* On 30th March 1961 Davies's (Tutors) Ltd. executed a deed of covenant whereby they agreed with the trustees of the charitable trust that

> "it the Company will out of the general fund of taxed income of the Company annually on the 5th April in every year for a period of seven years . . . pay to the trustees . . . such a sum as will equal in amount 80 per cent. of the" net profits of the company.

The remaining 20 per cent. was retained to meet profits tax. So the covenant was in effect to pay *all* the net profits of Davies's (Tutors) Ltd. (after deducting profits tax) to the trustees for the next seven years. These net profits came to about £12,500 a year. (3) *The purchase of Davies's by the trustees.* On 4th April 1962 the two trustees formed themselves into a company called Davies's Educational Developments Ltd. Its authorised capital was £100, of which two shares of £1 each were issued, one to each trustee. I will call it Davies's Developments Ltd. On 5th April 1962 Davies's Developments Ltd. by deed agreed to purchase from Davies's (Tutors) Ltd. the goodwill of Davies's. The value of the goodwill was put at £50,000 (which was a fair price) and Davies's Developments Ltd. were to buy it by five instalments of £10,000 a year. As soon as the £50,000 had been paid, Davies's Developments Ltd. agreed to buy from Davies's (Tutors) Ltd. all its premises and equipment at a fair market valuation by an independent valuer. (4) *The understanding.* The evidence established quite clearly that, when Davies's (Tutors) Ltd. entered into the deed of covenant of 30th March 1961, *an understanding* had been reached between all concerned that the covenanted payments would be used by the trustees to buy the business of Davies's (Tutors) Ltd. as a going concern. The intention of all the parties was that Davies's in its present form should be perpetuated in the hands of an educational trust, and that the equity shareholders of Davies's (Tutors) Ltd. should in due course receive a fair but not excessive price for the assets of that company. (5) *The income of the Trust.* The trustees received the first two instalments under the deed of covenant (due on 5th April 1961 and 5th April 1962) amounting to £25,831 12*s.* 2*d.* The trustees used this

(Lord Denning M.R.)

money, as to £10,000 in part purchase of the goodwill of Davies's (Tutors) Ltd., and as to £11,900 in the purchase of the trade fixtures of that company. A

The question is whether the trustees of the charitable fund are entitled to repayment of tax by the Inland Revenue in respect of the first two instalments they have received under the deed of covenant. This claim to repayment arises out of the provisions of the Income Tax Act 1952, ss. 123(1), 169(1) and 447(1)(*b*). They are so familiar that I will not read them again. Suffice it to B say that a trust established for charitable purposes only is entitled to exemption from tax

> "in respect of any yearly interest or *other annual payment,* forming part of the income of ... [the] trust ... so far as the same are applied to charitable purposes only".

The Davies's Educational Trust is admittedly a trust established for charitable C purposes only. So the two points are: (1) Were the payments under the deed of covenant "annual payments" forming part of the income of the Trust? (2) Were they applied to "charitable purposes only"?

It is a common practice nowadays for a man to make a seven-year covenant in favour of a charity. The object is to enable the charity to recover tax from the Revenue. The theory on which it works is best shown by an D illustration. Take a man who has a taxable income of £1,000 a year. He is taxed on the whole of the £1,000 at the standard rate of 8*s.* 6*d.* in the pound. It comes to £425. Now suppose he makes a covenant in favour of his parochial church council to pay them £10 a year for seven years. He is entitled to deduct tax at source before he pays the church council. He deducts tax at 8*s.* 6*d.* in the pound, which comes to £4 5*s.*, and pays the church council £5 15*s.* a year. E Now that £10 a year payable under the covenant is really the income of the church council. If you look at it from their point of view, it is £10 a year coming to them forming part of their income. Being their income, it ceases to be the income of the payer. So the £10 a year becomes the income of the church council, thus reducing the income of the payer to £990. Now you do not subject any income to tax twice over. That means that when he pays F tax on the full £1,000 he pays it both on his own income of £990 and on the church council's income of £10. In so far as he pays tax on the £990 he pays it on his own account. It is over and done with. In so far as he pays tax on the £10 he pays it on behalf of the church council. The church council has suffered tax by deduction of £4 5*s.* at source. But being a charity, the church council are not liable to tax on that £10. They are exempt. They can, there- G fore, recover it from the Revenue.

That illustration points the moral of this whole case. In order to be an "annual payment" within these sections, the payment must be such that it can be truly regarded as the income of the recipient taxable by deduction at source. Typical instances are mentioned in the Statute. "Yearly interest" can be illustrated by interest payable on loans. "Annuities" can be illustrated by H annuities granted by will or obtained by purchase from an insurance company. The words "other annual payments" are *ejusdem generis.* They are payments which recur each year in which nothing remains to be done by the recipient except to receive the money. The recipient is not to supply goods or services or give or do anything in return for the payment. If he does so, it is no longer an "annual payment". This appears from *Earl Howe* v. *Commissioners of Inland* I *Revenue*[1] [1919] 2 K.B. 336 and In re *Hanbury* (1939) 38 T.C. 588. In *Commissioners of Inland Revenue* v. *Corporation of London (as Conservators of*

(1) 7 T.C. 289.

Epping Forest[1] [1953] 1 W.L.R. 652, page 664, Lord Normand indicated that a sum would be an "annual payment" if it was paid "without conditions or counter-stipulations out of taxed income"; and this was adopted by Lord Evershed M.R. as a good guide in *Commissioners of Inland Revenue* v. *National Book League*[2] [1957] Ch. 488, at page 499.

Mr. Desmond Miller submitted that Lord Normand was referring only to conditions or counter-stipulations which were *legally enforceable;* and he argued that, even where there was only a *private understanding* that the covenantor should receive a counter-benefit (which was not legally enforceable) it was nevertheless an "annual payment". I cannot accept this submission in the least. A seven-year covenant is nullified for tax purposes by a private understanding, just as much as by a contractual stipulation. Take the common case of a covenant by a father to pay his son, who is over 21, £400 a year. If it is wholly the son's income without reservation, it is an "annual payment". But if there is a private understanding that the son should return it or part of it to his father in cash or in kind, then it is not an "annual payment" so as to qualify for tax benefits. The Royal Commission on the Taxation of Profits and Income, over which Lord Radcliffe presided, made a caustic reference to private understandings of this kind. They said:

> "We feel little doubt that a number of such understandings do exist and that they are no better than a fraud on the system". (See Cmd. 9474 (1955), para. 159.)

In the present case the Judge held that there was a legally binding obligation on the trustees to use the sums in paying for the purchase of Davies's. I decline to go into the question whether it was legally binding or not. I care not one way or the other. There was, as the Commissioners found, a clear understanding that they should be so used. That is enough. The moneys payable by the covenantors were being returned to them as part payment of the purchase price. It is said that it was a fair price and is no different from their buying another school. But I think there is all the difference in the world. By having the money returned to them, even in payment of the price, the covenantors were receiving a counter-benefit. Suppose a man gives a covenant for seven years to his old school, and in return there is a private understanding that his son, who is a dunce, will be given a place. The sum payable under the covenant does not qualify as an "annual payment", even though he pays the full fees for his son. The return benefit disqualifies. It cannot be ignored except when it is minimal and negligible: see the *National Book League* case, [1957] Ch., at page 506[3], per Morris L.J. and *Taw and Torridge Festival Society Ltd.* v. *Commissioners of Inland Revenue* (1959) 38 T.C. 603.

The Judge was influenced by the fact that the trustees were bound to apply the payment for the purchase of a capital asset. I do not think it matters that it was to be applied for the purchase of a capital asset. Income is none the less income, even though it is used to buy a capital asset. Its character is determined at the time of its receipt. The important thing is that it was committed to a purpose which benefited the covenantors, even if only by a private understanding. That takes it out of the category of an "annual payment".

This makes it unnecessary to consider whether it was applied for charitable purposes only. All I would say is that, seeing that it was applied in part for the purpose of a counter-benefit for the covenantors, I do not see how it can be said to have been applied for charitable purposes only.

(1) 34 T.C. 293, at p. 324. (2) 37 T.C. 455, at p. 470. (3) *Ibid.*, at p. 476.

(Lord Denning M.R.)

In my opinion, therefore, the sums payable under the seven-year covenant were not "annual payments". Davies's (Tutors) Ltd. are not entitled to deduct tax from the payments. The trustees are not entitled to claim back anything from the Revenue. I would therefore dismiss the appeal.

Harman L.J.—There are occasions, even in Revenue cases, when what you come to look for is substance and not form. Here were corporators owning a first-class educational business which paid 800 per cent. on its ordinary shares and made a living also for the majority shareholders. It paid tax, of course, like any other commercial concern. The object of the corporators was to sell this business at its full value without losing control of it. They left it to their accountant to find the best means, and what we have is his plan, which smells a little of the lamp. His plan was: (1) to sell the goodwill to a concern still controlled by the vendors; (2) to find the price out of the profits of the business; (3) to get back the income tax which was being paid by the vendors, thus accelerating the payment of the purchase money.

What were the steps taken to carry it out? The first was that a trust was set up, a trust for educational purposes only, and therefore a charitable trust, but, as its name implies, it was to be tied to Davies's, the name of the business. The object of the charitable trust was to take over the business from Davies's. The second step in this was the covenant which the company entered into the day after its formation, which was a covenant for seven years to pay 80 per cent. of its profits to the trust. The third step was that the trust was to use the money to pay for the business. I care not at all, like my Lord, whether this was a legally binding transaction or merely one that was morally binding on everybody. After all, all the participators in this scheme were on one side of the table. They were the corporators in this business. They were the people who were making a living out of it and who were hoping to get a good price for it. There is nothing wrong with that. But it makes a formal agreement quite unnecessary, because it was to everybody's interest and it was everybody's intention to carry it out in this way if it would get back the company's income tax. The fourth step was that the Trust, being a charity, was to apply to get back the income tax payable by the vendors and return it to the vendors directly it was got back and so hasten the payment of the purchase price.

It is on this last rock that the ship founders. If I pay my college at Oxbridge income payments over seven years, these are annual payments because I expect and get no return from my outlay. If I make conditions, such as a free place for my son, no tax is reclaimable. Judge the present case by this test. The covenantor makes his payment to the Trust. Everyone concerned knows the object of it: it is to get back the payments as instalments of the purchase money for the business—*item* to recover through the trust the tax it has paid, and return it to themselves as further instalments. No doubt, when the seven years are up, there is to be a further covenant on a further understanding that the covenanted sums will go to pay for the vendors' physical assets, freeholds and leaseholds. The prospect is that no one in this business will pay any tax for years. It is a splendid scheme. Meanwhile the business will remain under the control of the majority shareholders and provide them with salaries as managers of the business. It is almost too good to be true. In law quite too good to be true. It won't do. That is enough in my opinion to deal with this appeal. I follow Buckley J. until he reaches this point precisely; but his further reasoning I cannot follow, and so far as I can follow it, I do not accept it; but it makes no difference.

As to the second point, that the payments were applied for charitable purposes only, being payments made to buy an educational business, when

looked at it is essentially the same point at a different stage. The payments to be made by the covenantor are not in my opinion for charitable purposes only, because they are paid in pursuance of the understanding that they shall be devoted to the purchase of the business. Therefore it does not matter that the business is an educational business and therefore within the objects of the charitable trust, because the objects of the charitable trust are not wholly charitable in this case, but to pay for a business of which they themselves are the controllers.

On both points, therefore, I would dismiss the appeal.

Salmon L.J.—I have heard it said that golf is essentially an easy game made difficult. It seems to me that the question that arises in this case is essentially an easy question made difficult. It has been made difficult only by the irrelevant complexities and ingenuity under which it has been almost submerged.

The company, Davies's (Tutors) Ltd., covenanted to pay 80 per cent. of its annual profits to a charitable trust called the Davies's Educational Trust for a period of seven years. The company deducted income tax from those profits before paying them to the Trust. The Trust seeks to recover the tax that has been so deducted. The covenant was part of an arrangement found by the Special Commissioners to have been made between the directors and shareholders in the company and the trustees. There were only two trustees: one was a director of the company and the other was the company's secretary. It was the common intention of all those persons, as found by the Special Commissioners, and part of the arrangement between them, that every penny paid under the deed of covenant to the trustees should be returned to the company enriched by the tax that had been recovered, and that in return the company would transfer all its assets to the Trust. The first asset to be so acquired was to be the company's goodwill, valued at some £50,000. It is conceded that there was a moral obligation on the trustees to return the money to the company in the way I have indicated, but it is argued that there is no legal liability upon them to do so. There was, of course, no formal agreement between the parties interested because, as Harman L.J. has said, they were all on the same side of the fence: their interests were common and there was no need for any formal agreement.

I myself agree, however, with Buckley J. that each payment became the subject of a trust in the hands of the trustees and they were under an equitable duty to deal with those payments in accordance with the common intention of all the parties and the arrangements made between them. I should think it very remarkable if, in the highly unlikely event of the trustees using the money they received in breach of the understanding and for the purpose, say, of financing a school which was in competition with one of the schools belonging to the company, the Court of Chancery would be unable to intervene. I have no doubt that it would intervene to prevent what I think would be a clear breach of trust. But in my view it does not matter very much whether there was such a trust in respect of the money paid under the covenant or whether there was merely a moral obligation on the part of the trustees to return it. In no circumstances can it be regarded as pure bounty.

The case for the Appellants, as I understand it, is that the money which they received is an "annual payment" within the meaning of those words in the Income Tax Act despite the fact that the money is to be returned to the company; this, they say, is so because it is returned in payment for the company's assets and the price being paid for the assets is a fair and reasonable price. In order for the money paid under the covenant to constitute "annual

(Salmon L.J.)

payments" in the hands of the trustees, so that they can recover the tax that has been deducted, it is clearly established by such authorities as *Commissioners of Inland Revenue* v. *Corporation of London (as Conservators of Epping Forest*[1]) and *Commissioners of Inland Revenue* v. *National Book League*[2]) that the money must have been paid to the trustees without "conditions" or "counter-stipulations" or as a "pure gift" or "pure bounty". There may well be cases in which it would be difficult to decide whether what was paid to a trust was by way of pure gift or whether there were any counter-stipulations which prevented the money from being a pure gift or pure bounty. But this in my view is not one of those cases. Every penny which the charity received it had to return to those who gave it. It was certainly under a moral duty to do so, and in my view would be committing a breach of trust should it fail to do so. It seems to me to be entirely beside the point that, once the trustees had returned the money, they were going to receive in exchange an asset which would be of the same value as the money being returned. May I illustrate this point by an example? A enters into a covenant to pay a charitable trust, B, £10,000 a year for seven years. He does so, deducting tax. There is an understanding between A and B that B will pay £70,000 back to A as consideration for a house which A will then transfer to B. As I understand Mr. Miller's argument, providing the house is worth the £70,000, that is all right: the payments by A to B are pure bounty. If, however, the house is worth only, say, £10,000, Mr. Miller concedes that it would be ridiculous to regard the money paid by A to B as bounty. To my mind, however, the value of the house would be wholly irrelevant to the question with which we are concerned. A is not giving away any money: he is getting it back, plus the tax which he has deducted from it. What he is giving away is the house. Suppose the circumstances postulated but that the house is worth £200,000. If anyone asked the question what was A's bounty to B, no one would think of saying that A had made a gift to B of £70,000. Any ordinary man would say: "It is true that A has, for some mysterious reason, parted with that sum less tax and received it back plus the tax, but he has not given it away. He has been much more charitable than if he had given away a mere £70,000. What he has done in fact is to give away a property worth £200,000." So here, the most that can be said in favour of the Appellants is that the company is in fact giving away its assets to the Trust—certainly its goodwill. Unfortunately from the point of view of everyone concerned, except the Commissioners of Inland Revenue, that gift does not afford them any tax advantage.

There is only one other point I should like to mention, and it is this. According to the findings in the Case, the goodwill, which was the first asset to be "purchased", has been correctly valued at £50,000. The Case is not, however, particularly illuminating on this point, because it does not deal with the circumstances in which the goodwill could be said to be worth £50,000. When a business is sold, the usual form of the transaction is for the shares in the company carrying on the business to be sold either on a profit-earning basis or on an assets value basis; and one of the assets, of course, is the goodwill. In the present case there is no question of selling the company's shares to the Trust. The idea was for the company to transfer its assets to the Trust. One of those assets was the goodwill, valued at £50,000. Naturally if all the assets are made over and the company transferring them is a company such as this is, with a good name and a good profit record, the goodwill is no doubt worth a lot of money. When the goodwill is included amongst the assets sold, there is in the ordinary course always a covenant by vendors not in

(1) 34 T.C. 293. (2) 37 T.C. 455.

A future to trade under the same name or any name like it and quite often a covenant against competing with the purchasers. Having had some experience of contracts relating to the sale of assets of a business, I confess that I have never heard of anyone finding a purchaser who was prepared to buy goodwill alone. As far as I can see, the purchaser would be getting absolutely nothing, however valuable the goodwill might be if acquired with the other assets B and subject to the usual covenants. In the present case the company can still carry on the business under the old name. The Trust gets no share of the profit; it gets nothing except the chance of making some use of the goodwill if and when it receives sufficient money from the company to acquire the company's other assets with which the business is carried on. These include a large number of freehold and leasehold premises in London which will C cost a great deal of money. It is inconceivable that any sane person entering into an ordinary commercial transaction would buy goodwill in such circumstances. It seems to me, although perhaps it is not very relevant, that in this respect also the company and its corporators were, no doubt perfectly properly, receiving a real benefit by reason of this arrangement. They were receiving cash down from a goodwill in circumstances in which it would be D unsaleable on the open market.

However that may be, once the so-called benefactor is parting with his money under a covenant on the basis that the money is to come back to him, it seems to me to be obviously impossible, in any circumstances, if words have any meaning, to regard the payment of the money by the so-called benefactor as pure bounty. I agree that the appeal should be dismissed.

E **Goulding Q.C.**—I ask your Lordships to dismiss the appeal with costs.

Lord Denning M.R.—I think that follows, Mr. Simon.

Simon—We are here on appeal from the judgment of Buckley J. The learned Judge decided in our favour on the main stipulation and in our favour on charitable purposes. Here the appeal fails on the capital point. I submit it should be only two-thirds of the costs.

F **Lord Denning M.R.**—No, costs must follow the event. Appeal dismissed with costs.

Simon—Your Lordships will be expecting me to ask for leave. Your Lordships are differing from Buckley J., and I ask for leave.

Lord Denning M.R.—We are not differing.

(The Court conferred.)

G No, we do not give leave.

The trustees having obtained leave from the Appeal Committee of the House of Lords to appeal against the above decision, the case came before the House of Lords (Viscount Dilhorne and Lords Hodson, Guest, Upjohn and Donovan) on 11th, 12th, 13th, 17th, 18th and 19th June 1968, when judgment H was reserved. On 23rd October 1968 judgment was given unanimously in favour of the Crown, with costs.

(1)*Desmond Miller Q.C., S. W. Templeman Q.C., S. I. Simon* and *Mrs. M. C. Hoare* for the Appellants. The main question in this appeal is whether certain payments, admittedly received by the Appellants as trustees of a charitable trust, were annual payments within s. 169 of the Income Tax Act 1952 and therefore exempt from income tax under s. 447(1)(*b*) of that Act.

In the event of the decision of the Court of Appeal being reversed on the main question there arises a subsidiary question, namely, whether the income of the trustees was applied for charitable purposes only, and this the Special Commissioners and Buckley J. decided in the Appellants' favour.

The main question involves consideration of simple words in a simple context laying a simple charge to tax and no more. There is no definition of "annual payment" in either the Income Tax Act 1918 or the Income Tax Act 1952. For the nature of annual payment reliance is placed on the following propositions: (i) To constitute an annual payment under the Income Tax Act 1952 there must be a transfer of income. (ii) In order to decide whether a payment is income it is necessary to have regard to the character of receipt, that is, the capacity of receipt. (iii) An undertaking to supply goods or services given as the condition for the making of the payment determines the quality of receipt save what is received for that consideration can only be an ingredient in arriving at the balance of the profits and gains of the recipient. (iv) The above propositions are true because the undertaking to supply goods or services involves the recipient in expenditure. (v) The "condition" or "counter-stipulation" to which the authorities refer must be enforceable at law and must also involve the recipient in expenditure on the supply of the stipulated goods or services. (vi) Alternatively, if the authorities as properly understood do not compel the conclusion that the condition or counter-stipulation must be legally enforceable then it is the principle of *Earl Howe* v. *Commissioners of Inland Revenue* 7 T.C. 289; [1919] 2 K.B. 336 alone which can cause the payment to lose its income quality at receipt.

As to the judgments of the Court of Appeal, Lord Denning M.R.'s reference to the Royal Commission on the Taxation of Profits and Income (1955) (page 447 *ante*) is not a helpful analogy. It is not every return benefit which is disqualified from being an annual payment. For example, a son mortgages his house to his father; the father gives his son £1,000 on the understanding that it is to be used for paying off the mortgage; the son uses the money according to his father's wishes. The sums so used for paying off the mortgage cannot be said to form part of the father's income; it comes back to him in a different form. The opening remarks of Harman L.J. (page 448 *ante*) run counter to the facts found by the Special Commissioners, and his observations at page 448E are not in accord with the decision in *Commissioners of Inland Revenue* v. *Corporation of London* (the *Epping Forest* case) 34 T.C. 293; [1953] 1 W.L.R. 652. Further, as regards his judgment on the subsidiary question (pages 448–9), it is pertinent to observe that s. 447(1)(*b*) prescribes an objective test: contrast s. 137(*a*). As to Salmon L.J.'s observations at page 449GH, see the findings of the Special Commissioners. Further, his observations at pages 450G–451 overlook the provisions of the partnership deed.

The leading authority on annual payments is *Earl Howe's* case 7 T.C. 289, which was followed in In re *Hanbury* (1939) 38 T.C. 588: see also the valuable summary of the law on annual payments in *Commissioners of Inland Revenue* v. *Whitworth Park Coal Co. Ltd.* 38 T.C. 531, 548–50; [1958] Ch. 792 *per* Jenkins L.J., which is adopted. The *Epping Forest* case is not an extension of the principle of *Earl Howe's* case but merely an application of it to the facts of that case.

(1) Argument reported by J. A. Griffiths, Esq., and Miss C. J. Ellis, barristers-at-law.

A In *Commissioners of Inland Revenue* v. *National Book League* 37 T.C. 455; [1957] Ch. 488 the counter-stipulation was in a contractual form and involved the League in the expenditure of money in performing its obligations. Since 1919 that has been the only test in respect of a counter-stipulation. That case was correctly decided but the gloss there put upon the words used by Lord Normand in the *Epping Forest* case 34 T.C. 293 is not warranted.

B As to "condition" and "counter-stipulation", these are terms of art in relation to the formation of contracts. It appears from Chitty on Contracts (1961) 22nd edn., paras. 575, 578, that the words "condition" and "counter-stipulation" are wholly interchangeable in the law of contract.

[Reference was also made to *Commissioners of Inland Revenue* v. *Educational Grants Association Ltd.* 44 T.C. 93; [1967] Ch. 993; *Commis-*
C *sioners of Inland Revenue* v. *Frere* 42 T.C. 425; [1965] A.C. 402; *Commissioners of Inland Revenue* v. *Duke of Westminster* 19 T.C. 490; [1936] A.C. 1.]

S. W. Templeman Q.C. following. Section 123 of the Income Tax Act 1952 charges income tax under Case III of Schedule D on an annual payment payable as a personal debt or obligation by virtue of any contract. Section 169 enables the payer of an annual payment to deduct tax when making an
D annual payment payable as a personal debt or obligation by virtue of any contract. Section 447 exempts from income tax an annual payment forming part of the income of a charity and applicable and applied to charitable purposes only. The term "annual payment" must bear the same meaning throughout the Act; the term includes a payment made by virtue of any contract. A payment made by virtue of a contract cannot be "pure bounty"
E or "pure income profit". Therefore an annual payment does not cease to qualify for exemption under s. 447 merely because it is not "pure bounty" or "pure income profit". Section 447 requires an annual payment to be the income of the charity. In the present case the annual payment consists of the profits of the business; such profits cannot be capital and must either be the income of Tutors or the income of the charity. They are received by the
F charity and are accordingly the income of the charity and cannot be converted into capital merely because they may be saved and used to purchase the business. It has been suggested that the annual payment was a loan to be repaid as and when proportions of the business were given by Tutors to the charity. There was no loan in the present case because (i) there was no binding obligation on the charity to purchase the business; (ii) there was no relationship
G between the profits and the purchase price of the business.

Regard must be paid to the manner in which a transaction is carried out. Thus, suppose that the trustees of a charity who have not the requisite funds for the purpose wish to buy a school. The proprietor sells them the school for £50,000 and the trustees immediately mortgage the school back to the proprietor for £50,000. The only way in which the trustees can
H pay off the mortgage is by handing over the profits they make. The day before the sale the proprietor is entitled to the property and the profits. The day after the sale the proprietor is entitled to £50,000. The day after the sale the trustees are entitled to the school and to the profits. The proprietor might have preferred to deal with the trustees by agreeing to convey the school to the charity, but deferring the conveyance until the profits had
I accumulated to £50,000 and then conveying the property away to the trustees for nothing. If the proprietor had adopted this method, then the trustees would only be entitled to the profits made after the conveyance. In the present case Tutors ceased to be entitled to the profits as soon as the deed of covenant had been executed, and those profits became the income of the charity. The profits were given away and the business was sold. The fact that the profits could have been kept and the business given away is irrelevant.

If, contrary to our argument, it is necessary to show bounty, then the transaction was one of bounty. By selling their business Tutors obtained no financial advantage, for the sale was at an undervalue and the remuneration of the directors was at an undervalue. The operation of the covenant was the giving away of £10,000, in return for which Tutors received no more than the gratifying probability that Davies's would be established and would be continued on a permanent basis. The covenant did not give Tutors a financial advantage but merely preserved something which was for them of sentimental value.

The relationship between Tutors and the charity in so far as the covenant is concerned is that of donor and donee, and in so far as the partnership deed is concerned is that of vendor and purchaser. The two documents cannot be added together to substantiate a submission that it was a relationship of creditor and debtor. The fact that the transaction could have been carried out by way of a creditor-debtor relationship is irrelevant. The form of the covenant is quite contrary to a creditor-debtor relationship. The power conferred by clause 4(xii) is inconsistent with the proposition that the trustees bound themselves to buy the assets of the business. The provision of para. 3(*a*) of the deed of partnership are inconsistent with any binding obligation. This clause was totally misunderstood by the Court of Appeal: see page 445 *ante*. It does *not* bind the charity to buy. It would be wrong to bind the charity. True, there was a *scheme* to buy, but the scheme was not binding on the charity. The trustees of the charity could not have been sued for specific performance or for damages if, on obtaining £10,000 under the deed of covenant, they had refused to buy a fifth share under the partnership deed. If the relationship under the deed of covenant is that of donor and donee, it is immaterial that there was a binding agreement (which is denied) to buy the property.

As to the question whether the annual payments were applied for charitable purposes only, the following questions and answers arise: (i) To what were the annual payments applied? Answer, the purchase of an educational establishment. (ii) Was that purpose a charitable purpose? Answer, Yes, as is conceded by the Crown in their printed Case. (iii) Was the money applied to any other purpose? Answer, No. Since the purchase was a *bona fide* purchase and the price paid was not more than the market price, these three questions and answers determine the matter in the Appellants' favour: the moneys received by the charity pursuant to the deed of covenant were applied to charitable purposes only.

The Court of Appeal asked the question: Why was the money spent? But, as Lord Normand observed in the *Epping Forest* case, 34 T.C. 293, 322, "satisfaction of a motive must not be confused with consideration". In *Leahy* v. *Hawkins* (1952) 34 T.C. 28 if the doctor had been a charity he would have been entitled to deduct the annual sums there in question under Case III of Schedule D. [Reference was made to *Barclays Bank Ltd.* v. *Naylor* 39 T.C. 256; [1961] Ch. 7.]

One can look behind the constitution of a company to see why it came into existence: see *Rand* v. *Alberni Land Co. Ltd.* (1920) 7 T.C. 629. *Commissioners of Inland Revenue* v. *Educational Grants Association Ltd.* 44 T.C. 93; [1967] Ch. 993 is relied on as showing that duality of purpose is not fatal.

E. I. Goulding Q.C., J. Raymond Phillips Q.C. and *J. P. Warner* for the Crown. The essential matter in the present case is the finding of the clear understanding by the Special Commissioners: see (i) their finding in para. 5(*e*); (ii) their decision in para. 8(3), where it is also mentioned that the minority

A shareholders were parties to the understanding as well; (iii) also para. 8(5), stating that the deed of covenant is an essential part of the arrangement, whereas the partnership deed is treated quite differently: see para. 8(4).

The Commissioners were right to treat Developments as mere machinery, arising as it did from the understanding that Barber should implement the parties' intention which he did by the deed of partnership.

B The two essential submissions for the Crown are: (1) The deed of covenant entered into, in the circumstances shown by the Case Stated, did not, for income tax purposes, constitute a transfer of income from Tutors to the trustees. It follows that payments pursuant to the deed of covenant are not annual payments for the purposes of Case III of Schedule D, or s. 447 of the Income Tax Act 1952. (2) On the assumption that that submission is wrong, C the payments made by the trustees to Developments, though conceded to be an application of money, were not an application for charitable purposes only. Regarding the concession found in para. 5(*h*) of the Case Stated, it must be read in the light of Mr. Phillips's submission before Buckley J. [1966] Ch. 439, 425(1); see also Buckley J., at page 443E *ante*.

The question has been raised whether the final words of s. 447 apply to D the whole paragraph and whether putting money by was a charitable application: see *General Nursing Council for Scotland* v. *Commissioners of Inland Revenue* (1929) 14 T.C. 645, *per* Lord Sands, at page 653; *per* Lord Blackburn, at page 656; *per* Lord Morison, at page 659. However, the House will not be called upon to express a final opinion, because the Crown conceded that the loan of money was an application of the money, and in fact that question E does not arise.

The two questions raised do turn on the same facts. They concentrate attention on two different sectors of a circular process: payments by Tutors to the trustees and payments by the trustees to Developments. Both were stages in the execution of a contract, or, at any rate, a clear understanding.

On the first submission, one must consider the meaning of "annual pay- F ment" in ss. 169 and 170. The idea of annual payments rests on the conception of a transfer of the right to a certain quantity of income from A to B, so that while money is yet in A's hands he can be made to bear tax on it on B's behalf. The Royal Commission on the Taxation of Profits and Income (1955) Cmd. 9474, at page 48, is adopted as part of the Crown's argument.

The difficulties in construing s. 123 of the Income Tax Act 1952 arise G because Parliament has never defined "annual payment" (nor has it defined "income"). For present purposes it makes no difference if a payment is made in exchange for something else; whether it comes back for nothing or as the purchase price of something sold matters not. If it comes back fortuitously, that is an independent matter. If you give £100 a year to your son and he uses the first £100 to buy you a gun that is fortuitous and makes no difference, H but if there is an understanding first that he will buy the gun and then he will receive £100 a year, that is not an annual payment. One must beware of confusing "transfer of income" with "transfer of money". Transfer of income for tax purposes depends on the giving of title to income, making it proper for it to be taxed in the payer's hands. Normally when one spends money out of income one is not increasing income for tax purposes.

I The nearest one comes to a judicial definition of "annual payment" is that given by Scrutton L.J. in *Earl Howe's* case, 7 T.C. 289, 303, namely, that it is *ejusdem generis* with annual interest or annuities.

(1) Viz., that before the Special Commissioners the Crown stated that they were not going to contend that there had been no application of money received under the covenant, but argued that it had not been applied for charitable purposes only.

A yearly payment may fail to be an "annual payment" within s. 123: first, the yearly sum may be otherwise dealt with, expressly or by implication, under some provision of the Income Tax Acts other than Case III of Schedule D, the obvious example being a salary; secondly, the yearly sum may not be income within the scope of the Income Tax Acts at all, e.g. a voluntary allowance to a grandson; instalments of capital where an asset is sold for a capital sum by instalments.

The Crown's four submissions on "annual payments" in the Court of Appeal were: (1) It is necessary to examine the character of the payment both in the hands of him who pays and of him who receives: Sir Wilfrid Greene M.R. in In re *Hanbury* (1939) 38 T.C. 588, 590–1; see also *per* Sir Raymond Evershed M.R. in the *Epping Forest* case 34 T.C. 293, 309, and *per* Lord Normand 34 T.C. 293, 321. In general it is the hand that receives that provides the decisive test.

(2) Reported cases show that one of the matters to be taken into account in judging whether a payment is an annual payment is the character of the recipient: when one asks does this recipient receive pure income profit, it is important to see whether he is a trader or a charity or an individual who is neither: the doctrine of the *National Book League* case 37 T.C. 455 is right. As the Court of Appeal held, any counter-stipulation would prevent it being an annual payment.

(3) In charity cases, the most important question, generally decisive, is whether the payments are made unconditionally. Are they pure gifts?

(4) In charity cases, it is not essential to find a legally binding obligation on the part of the charity in order to say that the payment is not a pure gift. The Court should determine as a practical matter whether the payment is a pure gift or not.

"Heads of agreement" can be used in at least two senses: (*a*) points which will cease to operate at a future date by some fuller and more perfect agreement, e.g. marriage articles prior to marriage, subsequently replaced by a marriage settlement; (*b*) an agreement permanent in itself but requiring further matters to be worked out, which will not itself cease to exist when those further matters are settled. When the deed of covenant was entered into, it was in pursuance of an intention by the parties that further arrangements would be made but there was no question of a superseding arrangement or understanding.

[Reference was made to the *Epping Forest* case 34 T.C. 293, *per* Lord Normand, at page 324; *per* Lord Reid, at page 328; *Leahy* v. *Hawkins* 34 T.C. 28; the *National Book League* case, where the arguments throw some light on the judgments [1957] Ch. 488, 495. Vaisey J. did accept the Crown's argument in the circumstances of that case, 37 T.C. 455, 466–8; see also *per* Lord Evershed M.R. *ibid.* 469–74 and Morris L.J. *ibid.* 475–6; *Barclays Bank Ltd.* v. *Naylor* 39 T.C. 256, 267; *British Commonwealth International Newsfilm Agency Ltd.* v. *Mahany* 40 T.C. 550, 576, 578, 582; *Commissioners of Inland Revenue* v. *Frere* 42 T.C. 125, 147.]

The payments in question were not "annual payments". They were payments made by Tutors to the trustees to be used by the trustees in a particular way. They became the trustees' property subject to contractual obligations. The *Duke of Westminster's* case 19 T.C. 490 is distinguishable because the understanding was purely conditional and did not bind the employee in any way. That case does not say that one should disregard the understanding; one looks at the deed of covenant and enquires whether the understanding was one which created legally enforceable duties or not. [Reference was made to *Edwards* v. *Skyways Ltd.* [1964] 1 W.L.R. 349, 354.] As Buckley J. put it, the trustees were contractually bound, or if not, they were bound as by a trust:

see page 442 *ante*. Even if there was not a legally enforceable contract, nonetheless the clear understanding come to by the parties would deprive the covenanted sums of their character of annual payments under the Income Tax Acts.

With regard to the Appellants' propositions (i) is accepted, though the Crown would prefer a "grant of income" rather than "a transfer"; (ii) the Crown does not quarrel with the second proposition, but would prefer to adopt Lord Cohen's view in *Mahany's* case 40 T.C. 550, 578 that one must look at all the circumstances; (iii) is a statement of the type of case given as an illustration by Scrutton L.J. in *Earl Howe's* case 7 T.C. 289, 303, which is accepted, subject to the proviso that the illustrations are not exhaustive; (iv) is accepted subject to (iii); (v) is founded on the *National Book League* case 37 T.C. 455, and the Crown would uphold that decision that counter-stipulation is enough; on (vi) the fact that it is a trade receipt is not the only reason that it fails to be income; it may be capital. That distinction is clearly brought out in *Commissioners of Inland Revenue* v. *Paterson* (1924) 9 T.C. 163.

On the second alternative main submission, under s. 447(1)(*b*) a double test has to be satisfied. It is conceded that the trust was established for charitable purpose only, but it is contended that the money in question was not applied to charitable purposes only. The Crown disagrees with Mr. Miller's submission contrasting s. 137, and submits that there is no distinction between the purposes in the two sections and that they mean the same thing in both contexts. In the present case there were two separate purposes in contemplation and execution throughout as set out by the Commissioners in their findings in para. 5(*e*) and in their decision in para. 8(5).

One must not confuse "motive" with "consideration": *Barclays Bank Ltd.* v. *Naylor* 39 T.C. 256, 268. "Purpose" was considered in *Chandler* v. *Director of Public Prosecutions* [1964] A.C. 763, 794–5.

J. Raymond Phillips Q.C. followed.

[VISCOUNT DILHORNE intimated that their Lordships only desired to hear argument in reply on the first main submission.]

Miller Q.C. in reply. It seems that the Court of Appeal's decision that a canon of income tax law says that, if funds are applied to a particular end, that end being capital, the sum is *a fortiori* capital is not being supported. The Court of Appeal clearly accepted that the sums paid to the trustees were income of the trustees: see page 447 *ante*.

As to the question, if A gives B money on the understanding that in due course B will give it back to A, will it ever form part of B's income, that is a dangerous ellipsis of the situation for the purposes of considering "annual payment" because it confuses two issues. If A pays money to B under a deed of covenant, the fact that B is to use it for a particular purpose does not alter its nature. The fact that he applies it to acquire an asset does not alter its character as a receipt. *Earl Howe's* case 7 T.C. 289 has stood for 50 years and has been approved in *Frere's* case 42 T.C. 125. It may be that the extent of the charitable relief under s. 447 is excessive, but the method of curtailing it is not by attacking the principle affecting annual payments which has stood for so long.

Viscount Dilhorne—My Lords, on 6th May 1946 a company called Davies's (Tutors) Ltd. (hereafter referred to as "Tutors") was incorporated. Its share capital was originally £4,000 divided into 3,890 5 per cent. cumulative preference shares of £1 each and 110 ordinary shares of £1 each. Mr. Campbell, Mr. McBride and Mr. Hall were directors, and Mr. Fairfax-Jones, whose wife

(Viscount Dilhorne)

was a shareholder, its solicitor. The company was formed to take over as a going concern the business of Davies's, a well-known and reputable organisation which was providing tuition at a number of schools in different parts of the country. This organisation had since 1952 been under the control of Messrs. Campbell, McBride and Hall.

The directors and shareholders in the company were aware for some time prior to 29th March 1961

> "that it would be difficult, if not impossible, to find individuals who were both qualified to run Davies's and possessed of sufficient capital to purchase the organisation as a going concern".

The Case stated by the Special Commissioners says, in para. 5 (*e*), that they

> "were anxious that Davies's should continue on an established and permanent basis, and they conceived the idea that a charitable trust should be set up to acquire Davies's."

So on 29th March 1961 Davies's Educational Trust was created by a declaration of trust made by Mr. Campbell and Mr. Fairfax-Jones, who were to be the trustees of the Trust—which was admitted to be a trust for charitable purposes only within the meaning of s. 447(1)(*b*) of the Income Tax Act 1952. The next day Tutors entered into a deed of covenant, which was also executed by the trustees of the Trust, whereby Tutors covenanted to pay to the trustees out of its general fund of taxed income annually on 5th April in every year for seven years commencing on 5th April 1961 "such a sum as will equal in amount 80 per cent. of the profits or gains accruing to" Tutors in the immediately preceding year, the first payment to be made on 5th April 1961. The figure of 80 per cent. was chosen because the payments to be made to the trustees would not be deductible in computing the profits of Tutors for profits tax purposes. 20 per cent. of the net profits was therefore retained for profits tax purposes, and, as the Case Stated says, "the trustees, in effect, were to get the whole of the net profits of Tutors after meeting profits tax." Before 1962 Tutors had paid dividends of 800 per cent. on its ordinary shares as well as the preference dividends. Since then no dividends have been paid on the ordinary shares.

The Special Commissioners, in para. 5 of the Case Stated, found, *inter alia,* that the deed of covenant was entered into on the clear understanding by the directors and shareholders of Tutors and the trustees that the net sums payable thereunder, together with the income tax thereon (which it was thought would be recoverable under s. 447(1)(*b*)), would be used by the trustees to purchase the business of Davies's. "There was no doubt in the minds of any of the parties that the trustees would use these moneys to acquire Davies's business." The Commissioners gave their decision in writing, and again said that the evidence established quite clearly that, when Tutors entered into the deed of covenant on 30th March 1961, an understanding had been reached between the three directors of Tutors and the rest of the shareholders and the trustees that the covenanted payments would be used by the trustees to buy the business of Tutors as a going concern.

> "The intention of all these parties was that 'Davies's', in its present form, should be perpetuated in the hands of an educational trust and that the equity shareholders of Tutors should in due course receive a fair but not excessive price for the assets of Tutors. This understanding that the covenanted payments would be so used" the Special Commissioners found "to be a condition or counter-stipulation attached to the deed of covenant."

It was left to a Mr. Barber, the auditor of Tutors, to work out "the detailed implementation of the plan for the Trust to acquire the business of Tutors by means of the covenanted payments", and on 4th April 1962 a company called

A Davies's Educational Developments Ltd. (hereafter called "Developments") was incorporated. It had a share capital of £100 divided into 100 £1 shares. Two of the shares were issued, one to Mr. Campbell and the other to Mr. Hall, both directors of Tutors, and held by them as trustees of the Trust. The directors of Developments were Mr. Campbell, Mr. McBride and Mr. Hall, who were also the directors of Tutors. The object of the company was, *inter*
B *alia,* to promote, carry on, further and encourage educational work of every description. The next day, 5th April 1962, a deed of partnership was entered into by Tutors and Developments "for the purpose of carrying on and developing as may be determined the business and work hitherto carried on by Tutors alone." Clause 3(*e*) of the deed provided that Developments should immediately after the execution of the deed purchase from Tutors a one-fifth share
C of the goodwill of £50,000 of the business for £10,000, and that Developments might in any subsequent year purchase from Tutors at a fair market valuation the freehold and leasehold premises then vested in Tutors together with all trade fixtures, etc., of Tutors. During the year ended 5th April 1963 the trustees advanced £21,900 to Developments, £10,000 of which was used to purchase a one-fifth share of the goodwill in Tutors and £11,900 to purchase the trade
D fixtures, etc.

The formation of Developments and the creation of the partnership were part of the machinery for carrying out the understanding arrived at on the basis of which the deed of covenant was entered into. The practical consequences of the understanding were that the equity shareholders of Tutors were to get a fair price for Tutors' assets out of moneys provided by Tutors
E which otherwise might have been distributed to them by way of dividend, and a price to which it was hoped that the Inland Revenue would contribute by refunding to the Trust the tax deducted by Tutors under s. 169(1) of the Income Tax Act 1952 on making the payments under the deed of covenant. The future of Davies's was to be put on an established and permanent basis, not just by transferring the assets of Tutors to the Trust, but by their transfer on payment
F of a fair price paid out of moneys provided by Tutors and, it was hoped, provided by the Inland Revenue. The main, if not the only, object of this curious financial transaction which was to precede the transfer of the assets was to secure the recovery of tax from the Inland Revenue.

Section 169(1) of the Income Tax Act 1952 provides, *inter alia,* that:

> "Where any yearly interest of money, annuity or other annual
G payment is payable wholly out of profits or gains brought into charge to tax— . . . (*c*) the person liable to make the payment . . . shall be entitled, on making the payment, to deduct and retain out of it a sum representing the amount of the tax thereon at the standard rate for the year in which the amount payable becomes due".

The payments made by Tutors under the deed of covenant were annual pay-
H ments, and it was not disputed that they were paid wholly out of profits or gains brought into charge to tax. Tutors, therefore, on making the payments under the deed were entitled to deduct tax if the annual payments under the deed were annual payments within the meaning of the section. Section 447(1) of the Act provides that exemption from income tax shall be granted:

> "(*b*) from tax chargeable . . . in respect of any yearly interest or other
I annual payment, forming part of the income of any body of persons or trust established for charitable purposes only . . . and so far as the same are applied to charitable purposes only".

In this appeal two questions have to be decided: first, whether the payments made under the deed of covenant were annual payments within the meaning

(Viscount Dilhorne)

of ss. 169(1) and 447(1), and, secondly, if they were, did the trustees apply the money so received for charitable purposes only.

For s. 169(1) to apply the annual payments must be paid out of income which has borne tax and also have the character of income in the hands of the recipient. For s. 447(1) to apply the annual payment must "form part of the income" of the recipient. If it has not that character in the hands of the recipient, he should not suffer tax on it by deduction of tax by the payer, and the payer is not entitled to reduce his income tax liability by deducting from the payment the amount of tax paid thereon. So the first question to be decided is whether the payments under the deed of covenant received by the trustees formed part of the income of the Trust.

The meaning to be given to "income" is not defined in the Income Tax Act 1952. Not every receipt of money paid under a covenant is to be regarded as forming part of the income of the recipient. This was recognised in *Earl Howe* v. *Commissioners of Inland Revenue*(1) 7 T.C. 289, where Lord Howe claimed to be entitled to deduct tax from the annual premiums for life insurance which he had covenanted to pay. In the course of his judgment Sir Charles Swinfen Eady M.R. said that under the corresponding provisions of the earlier Acts no deduction could be made in respect of an annual payment which was not subject to tax, and Warrington L.J., at page 300, said that in his opinion the annual payments referred to were

> "those and only those which for taxation purposes are treated as income, not of the payer, but of the recipient, in respect of which the latter has to bear the duty." He held that the annual payments which Lord Howe had made under covenant did not come within the provisions of the sections then in force, and said: "They are in truth instalments of purchase money for a capital sum payable on death. They go no doubt to swell the profits and gains arising or accruing to the Assurance Company on which Income Tax is chargeable, but the tax is not charged on the premiums themselves."

Scrutton L.J. said, at page 303:

> "It is not all payments made every year from which Income Tax can be deducted. For instance, if a man agrees to pay a motor garage £500 a year for five years for the hire and upkeep of a car, no one suggests the person paying can deduct Income Tax from each yearly payment. So, if he contracted with a butcher for an annual sum to supply all his meat for a year, the annual instalment would not be subject to tax as a whole in the hands of the payee, but only that part of it which was profits. . . These premiums are either payments of capital to obtain on the death a sinking fund—the policy moneys—or the price of such a payment or fund. They do not seem to me to be annual payments *ejusdem generis* with annual interest or annuities, and as Income Tax on them cannot be deducted against the recipient, I see no reason why the person paying should deduct them from his taxable income."

That case was followed in In re *Hanbury* (1939) 38 T.C. 588, where Sir Wilfrid Greene M.R. said, at page 590:

> "There are two classes of annual payments which fall to be considered for Income Tax purposes. There is, first of all, that class of annual payment which the Acts regard and treat as being pure income profit of the recipient undiminished by any deduction. Payments of interest, payments of annuities, to take the ordinary simple case, are payments which

(1) [1919] 2 K.B. 336.

A are regarded as part of the income of the recipient, and the payer is entitled in estimating his total income to treat those payments as payments which go out of his income altogether. The class of annual payment which falls within that category is quite a limited one. In the other class there stand a number of payments, none the less annual, the very quality and nature of which make it impossible to treat them as part of the pure profit income
B of the recipient, the proper way of treating them being to treat them as an element to be taken into account in discovering what the profits of the recipient are."

It follows from these decisions that annual payments which are to be treated as an element to be taken into account in computing the profits of the recipient are not to be regarded as annual payments coming within ss. 169(1)
C and 447(1) of the 1952 Act; but it does not follow that annual payments from which no deductions fall to be made for the purpose of computing profits or gains are to be treated as "forming part of the income" of the recipient and as coming within these sections. "The very quality and nature" of the payments may make it "impossible to treat them as part of the pure profit income of the recipient"([1]) as, for instance, "instalments of purchase money for a capital sum
D payable on death" (*per* Warrington L.J. in *Earl Howe's* case([2])) or loans.

In *Commissioners of Inland Revenue* v. *Corporation of London (as Conservators of Epping Forest)*([3]) 34 T.C. 293 a similar question arose. Lord Normand, at page 320, said that Donovan J. had

> "addressed himself to a real and not a verbal distinction, whether the sum received by the Respondents was an item of revenue or receipt in their
E hands against which their expenses have to be set, or whether it was income in their hands."

Towards the conclusion of his opinion he said, at page 324:

> "The sum, in my opinion, is in no different position from a sum (having the requisite quality of recurrence) paid without conditions or counter stipulations out of taxed income under a covenant by a private
F individual to any charitable body."

This observation has been taken, in my view wrongly, to imply that any sum paid subject to a condition or counter-stipulation will not qualify as an annual payment coming within the two sections. In *Commissioners of Inland Revenue* v. *National Book League*([4]) 37 T.C. 455 certain members of the League had covenanted to pay their subscriptions for at least seven years, and, to induce
G them to do so, they had been told that they would within the period of their covenants be exempt from any increase of subscription and be able to enjoy what may be described as some of the amenities of a London club. It was held that the League was entitled to recover the tax deducted from the payments made to it under the covenants. Lord Evershed M.R., at page 473, said:

> "The question, therefore, as I see it, turns first upon this: looking at
H the substance and reality of the matter, can it be said that those who entered into these covenants have paid the sums covenanted without conditions or counter stipulations?"

He said that the answer to this question was in the negative, and so held that the League was not entitled to recover the tax. Morris L.J. based his conclusion on a different ground. He said, at page 475:

([1]) 38 T.C. 588, at p. 590. ([2]) 7 T.C. 289, at p. 300. ([3]) [1953] 1 W.L.R. 652.
([4]) [1957] Ch. 488.

(Viscount Dilhorne)

> "If the payments were made in such circumstances that the League was obliged to afford to the covenantors such amenities and such benefits of membership as would at any particular time be offered to all members, and if those amenities and benefits were appreciable and not negligible, then I do not think that the payments were pure income profit in the hands of the charity."

On the basis on which Morris L.J. founded his judgment, the decision in that case was, in my opinion, clearly right; but that decision cannot, I think, be justified on the ground that there was a condition or counter-stipulation that during the period of the covenants the covenantors would be exempt from any increase of subscription.

Following the decision in the *National Book League* case(1), the Special Commissioners in this case held that, as there was a condition or counter-stipulation attached to the payments under the deed of covenant, those payments were not annual payments within the meaning of the two sections. The Court of Appeal dismissed the Appellants' appeal on this ground: see *per* Lord Denning M.R.(2) [1967] 2 W.L.R. 1445, at page 1455; Harman L.J.(3), at page 1458, and Salmon L.J.(4), at page 1459. I do not thing that Lord Normand intended the words he used in the *Epping Forest* case(5) to be so interpreted In that case, it seems to me, he was dealing with conditions and counter-stipulations relating to the supply of goods or services, where the result would be that the sums received were taken into account for the purpose of computing profits or gains. Further, s. 169(2) of the Income Tax Act 1952 provides that subs. (1) shall have effect "whether the interest, annuity or annual payment . . . (*b*) is payable . . . as a personal debt or obligation by virtue of any contract". If an annual payment payable by virtue of a contract comes within s. 169(1), it must follow that the fact that there is consideration for the promise to pay, whether or not in the form of a condition or counter-stipulation, does not necessarily exclude the annual payment from the scope of the sections. If, however, the consideration, condition or counter-stipulation relates to the provision of goods or services, and so deprives the payments of the character of "pure income profit", it will have that effect: *Earl Howe's* case 7 T.C. 289; In re *Hanbury* 38 T.C. 588.

Even if the condition or counter-stipulation is not of the character which will exclude the annual payments from the provisions of the sections, it has, for the payments to come within the sections, still to be established that they form part of the income of the recipient. Buckley J. based his decision in this case in favour of the Crown on the ground that the annual payments were not in his judgment "income in the hands of the trustees". He said (6), [1966] 2 W.L.R., at page 1462:

> "Each payment is received by the trustees committed to its being applied in its entirety to the purchase of a capital asset, which, as the Case Stated makes clear, it was the intention of all parties that the trustees should retain and maintain as a going concern. Indeed the preservation of the business was the basic objective of the whole transaction. The covenanted payments, if, as I am prepared to assume, they ought to be regarded as belonging to the trustees in a real sense at all, were, in my judgment, contributions or accretions to the capital stock or endowment of the trust and were just as truly receipts on capital account and not on account of income as instalments of the proceeds of sale of a capital asset would be.

(1) 37 T.C. 455. (2) *See* pp. 446–7 *ante*. (3) *See* page 448 *ante*.
(4) *See* pp. 449–50 *ante*. (5) 34 T.C. 293, at p. 324. (6) *See* page 443 *ante*.

A As such they were not, in my opinion, *ejusdem generis* with interest on money and annuities belonging to the trustees."

Whether the payments made by Tutors to the trustees on the clear understanding that they would be used to buy Tutors' business and so returned to Tutors can properly be regarded as ever belonging to the trustees in a real sense at all, or whether they were in truth receipts on capital account in the hands of B the trustees, or whether they were nothing more than loans to the trustees on repayment of which assets of Tutors were to be transferred to the Trust, they had not, in my opinion, the quality and nature of income in the hands of the trustees. I full appreciate that the object of Tutors and of the trustees in making and receiving these payments was to attach to them the character of income so that tax could be deducted by Tutors and recovered by the Trust, C but in my opinion the condition as to the return of the money to Tutors deprived the payments of the character of income just as much as if, instead of the return of the money, the condition or counter-stipulation had been the provision of goods or services by the Trust to Tutors. The position is not in my view altered by the fact that when the trustees complied with the condition Tutors were to transfer their assets to the Trust. It was argued that the condition D attached to the payment of the moneys was not a legally enforceable obligation on the trustees, and it was pointed out that in the Case Stated the Commissioners did not expressly say that they found that there was a contract between Tutors and the trustees. While this is true, what they found, in my opinion, clearly amounted to a finding that there was a contract between them and so a legally enforceable obligation on the trustees to comply with the understanding. E The Commissioners found that the clear understanding as to the application of the money by the trustees was a condition or counter-stipulation, words which are appropriate in relation to a contract.

I now turn to the second question in this case, namely, were the moneys received by the trustees "applied to charitable purposes only"? The Crown argued that they were not, on the ground that they were used for the benefit F of Tutors by securing the sale of the assets and goodwill of their business. In fact the moneys paid by Tutors to the trustees were not directly applied by the trustees in the purchase of assets of Tutors, nor were they directly repaid by the trustees to Tutors. As has been said, they were advanced to Developments and used by Developments for the purchase of assets from Tutors. Nevertheless, in the Courts below the case has proceeded upon the basis G that the moneys were repaid by the trustees to Tutors for the purchase of the latter's assets, and I propose to proceed upon that assumption.

In the Court of Appeal Lord Denning M.R.([1]), [1967] 2 W.L.R., at page 1457, said that he did not see how it could be said that the money had been applied for a charitable purpose only when it had been applied "in part for the purpose of a counter-benefit for the covenantors", and Harman L.J.([2]), at H page 1458, held that the payments were not for charitable purposes only "because they are paid in pursuance of the understanding that they shall be devoted to the purchase of the business." Buckley J., on the other hand, held that the moneys were applied to charitable purposes only. At [1966] 2 W.L.R. 1463([3]), he said:

"The purchase by the trustees of the business of Davies's is charitable. I The whole of the £21,900 has been applied for that charitable purpose. . . . It is not, in my judgment, necessary or permissible to consider what reason

([1]) *See* page 447 *ante*. ([2]) *See* page 449 *ante*. ([3]) *See* pp. 443–4 *ante*.

(Viscount Dilhorne)

> or motive the trustees may have had for their method of applying the money, or whether they were under any obligation to adopt that method, or whether it may have conferred some incidental benefit on someone else. . . . The requirements of s. 447(1)(*b*) are in my judgment satisfied as soon as it is shown that the body claiming relief from tax is established for charitable purposes only and that the sum in respect of which relief is claimed has been wholly applied to charitable purposes."

I entirely agree with Buckley J. To determine whether the money has been applied to charitable purposes only, one has to see how it has been applied and if it has only been applied for a charitable purpose. It will not cease only to be applied for such a purpose because there was an obligation to apply it in that way.

Although the money was, in my opinion, applied for a charitable purpose only, as in my view it never formed part of the income of the Trust I am of the opinion that this appeal should be dismissed.

Lord Hodson—My Lords, this appeal arises from the decision of the Special Commissioners, affirmed by Buckley J. and the Court of Appeal, rejecting a claim for repayment of income tax for the years 1960–61 and 1961–62. These sums were deducted by a company name Davies's Tutors Ltd. (which I will call "Tutors") on making payments for those years to the trustees of the Davies's Educational Trust, who are the Appellants, under a deed of covenant. The Appellants claim repayment by virtue of s. 447(1)(*b*) of the Income Tax Act 1952, which grants exemption from income tax in respect of

> "tax chargeable under Schedule D in respect of any . . . annual payment forming part of the income of any . . . trust established for charitable purposes only, or which . . . are applicable to charitable purposes only, and so far as the same are applied to charitable purposes only".

By declaration of trust dated 29th March 1961 the Appellants were appointed trustees and directed to hold the trust fund and the income thereof for the promotion and furtherance of education. By deed of covenant dated 30th March 1961 Tutors covenanted with the trustees to pay to them annually on 5th April in each year for seven years commencing 5th April 1961 a sum equal to 80 per cent. of the net profits or gains chargeable under Case I of Schedule D, less capital allowances. £25,527 4*s*. was accordingly paid for the two years ending 5th April 1962, after deduction of income tax at the standard rate. On 4th April 1962 the trustees caused the incorporation of a company, Davies's Developments Ltd. (which I will call "Developments"). This is wholly owned by the trustees through the medium of shareholding. The trustees advanced on loan the sum of £21,900 to Developments, which was used as to £10,000 to purchase a one-fifth share in the goodwill of the business of Tutors, and as to £11,900 in the purchase of certain fixed assets of the business. It was admitted by the Crown that the advance was an "application of the income of the trust" for the two years, but not that it was an application for charitable purposes only. On 5th April 1962 Tutors entered into a deed of partnership with Developments for the purpose of carrying on the business of Davies's formerly carried on by Tutors. Under the terms of the deed the goodwill of the business was agreed at £50,000, and it was provided that Developments should purchase from Tutors a one-fifth share of the goodwill at the price of £10,000 and that Developments might in any subsequent year calculated from 6th April 1962 purchase the residue of the goodwill or proportions of it in units of £10,000. Provision was made in the deed for the partnership to rent from Tutors the premises in which Davies's was carried on and the fixtures, fittings, books, etc., in the premises, and also for Developments to buy at a fair price

A the premises, fixtures, etc. in the event of the partnership being determined by Developments acquiring the whole of the goodwill of the business. Before the execution of this deed an accountant named Mr. Barber, who acted as auditor to Tutors and had the full confidence of all concerned, had valued the goodwill at not less than £50,000 on the basis of a sale at arm's length between a willing seller and purchaser. In his view the goodwill was worth between £50,000 B and £57,000.

Two questions only emerge: (1) were the payments, admittedly received by the Appellants as trustees of a charitable trust, "annual payments" within s. 447(1)(*b*) of the Income Tax Act 1952? (2) were the payments applied to charitable purposes only within the same section? If the Appellants are right a scheme has been successfully devised, the beauty of which is that the money C paid by Tutors to the Appellants comes back to them enriched by repayment of tax, which is capital in their hands.

The leading case of *Earl Howe* v. *Commissioners of Inland Revenue* 7 T.C. 289 is of assistance in determining upon what principle the meaning of the words "annual payments" in their context should be ascertained. Lord Howe had mortgaged his life interest in settled estates, including in the security D insurance policies on his own life upon which he covenanted to pay the premiums. In the event of failure to pay the premiums the mortgagees were empowered to pay them and charge the mortgaged property with them. Lord Howe paid the premiums and claimed to deduct the amount paid as premiums in computing his total income for super-tax. His claim failed on the ground that these were not "annual payments" subject to income tax. Warrington L.J., E at page 300, described them as "in truth instalments of purchase money for a capital sum payable on death". Scrutton L.J., at page 303, referring to the then relevant sections, said:

> "The result of these Sections seems to be that the 'annuities, interest, and other annual payments' which can be deducted to obtain exemption are those from which the claimant can deduct tax on behalf of the F recipient; being in effect the profits of the recipient who bears the tax, they are not also to be treated as profits of the person paying them. If no tax can be deducted on behalf of the recipient, they cannot be treated as profits of the recipient, and must be treated as paid out of profits of the person paying, who is therefore to be taxed on them." The Lord Justice proceeded to give illustrations of the proposition that it is not all payments made G every year from which tax is deducted. He said: "For instance, if a man agrees to pay a motor garage £500 a year for five years for the hire and upkeep of a car, no one suggests the person paying can deduct Income Tax from each yearly payment. So, if he contracted with a butcher for an annual sum to supply all his meat for a year, the annual instalment would not be subject to tax as a whole in the hands of the payee, but only that part of it H which was profits. . . . As said by Bramwell B. in *Foley* v. *Fletcher* (1858) 3 H. & N. 769, 783, it cannot be taken that the Legislature meant to impose a duty on that which is not profit derived from property but the price of it."

Although *Earl Howe's* case was concerned with the payment of insurance premiums under covenant, it seems to me that the approach to this case should I be the same.

It was found by the Special Commissioners to have been clearly established that, when Tutors entered into the deed of covenant of 30th March 1961, an understanding had been reached between the directors and shareholders of

(Lord Hodson)

Tutors, on the one hand, and the trustees, on the other hand, that the covenanted payments would be used by the trustees to buy the business of Tutors as a going concern. The intention of the parties was that Davies's in its present form should be perpetuated in the hands of an educational trust and that the equity shareholders of Tutors should in due course receive a fair but not excessive price for the assets of Tutors. The implementation of these intentions was left to Mr. Barber. Although the precise terms for working out the common purpose of the parties were left open, this is not to say that the agreement was unenforceable so far as the use of the covenanted payments was concerned. These were as a matter of contract to be used for the purchase of the business. The intervention of the incorporation of Developments and its agreement with the trustees on 4th and 5th April 1962 respectively does not, in my opinion, mean that there had not previously been a concluded contract. It matters not that the purchase price was dependent on profits from Tutors being forthcoming, and that it was therefore necessary that the provision for the purchase of the residue by Developments was permissive and not mandatory. Tutors were providing a capital sum by instalments for the purchase of their business, and the trustees were contractually bound to apply all the sums received by them under the covenant for that purchase. I express no opinion as to the position in the absence of a contractual obligation.

The Appellants sought to rely on *Earl Howe's* case(1), since they were able to asert with justice that the illustrations given by Scrutton L.J. dealt with trading receipts. They argued that the payments in question here were not made to supplement trading receipts nor for services rendered and were therefore income in the hands of the recipients. I do not think this last conclusion follows from the illustrations given. True these were not trading receipts, but they were *instalments of capital,* and as such do not fall within the scope of "annual payments" in s. 447(1)(*b*). Accordingly, the appeal must fail.

It is, however, desirable to add that some misconception seems to have entered into this case in view of statements in earlier cases about "conditions or counter-stipulations", as if the existence of such was inconsistent with what has been called "pure bounty", in the absence of which tax cannot be recovered in circumstances such as form the background for this claim. The "pure bounty" argument was advanced by the Crown throughout, was accepted by the Commissioners, although not by the learned Judge, found favour in the Court of Appeal and was finally advanced before your Lordships. I do not think this argument is tenable, if for no other reason than that Case III of Schedule D itself refers to "any annuity or other annual payment, whether such income is payable . . . either as a charge . . . or as a personal debt or obligation by virtue of any contract". In s. 169(1) and (2) of the Income Tax Act 1952 "annual payments" are referred to as including a personal debt or obligation by virtue of any contract. The speeches of the majority of your Lordships in *Duke of Westminster* v. *Commissioners of Inland Revenue*(2) 19 T.C. 490 deal with covenanted payments, in the alternative, on the footing that they were paid under contract.

The words "conditions or counter-stipulations" are to be found in a speech of Lord Normand in *Commissioners of Inland Revenue* v. *Corporation of London (as Conservators of Epping Forest)* 34 T.C. 293 (at page 324). The decision finally turned on the construction of an Act of Parliament, and the language of Lord Normand was not directed to the laying down of any principle of law such as is contended for by the Crown. It was, however, adopted as a principle, and was, I think, the *ratio decidendi* of the judgment of Lord

(1) 7 T.C. 289. (2) [1936] A.C.1.

Evershed M.R. in the Court of Appeal in *Commissioners of Inland Revenue* v. *National Book League* 37 T.C. 455. There, in response to an appeal by the chairman of the League in which he stated that the execution of a covenant would insure a member against any increase in subscription rates for seven years and referred to the incidental benefits of membership as considerable, members entered into deeds of covenant for payment of their subscriptions expressed as net sums after deduction of income tax. The League made claims under s. 447(1)(*b*) of the Income Tax Act 1952 for recovery of tax, and succeeded before the Special Commissioners on the ground that advantages afforded to members were trifling and that the facilities could be disregarded as minimal. The Crown contended that the payments were received in consideration of the annual provision of goods and services and so were not annual payments within the meaning of the Income Tax Acts. The decision can be supported on the broad ground that the payments were in the nature of annual subscriptions to a club, but Lord Evershed M.R., taking up the expression "conditions or counter-stipulations" to which I have earlier referred, which is to be found in Lord Normand's speech in the *Epping Forest* case[1] used language which, in my opinion, goes too far. He said, at page 473:

> "The question, therefore, as I see it, turns first upon this: looking at the substance and reality of the matter, can it be said that those who entered into these covenants have paid the sums covenanted without conditions or counter-stipulations? On the whole I have come to the conclusion that they cannot so say . . . there was here, in a real sense, a condition or counter-stipulation on the part of the League against which the covenant was entered into."

Lord Evershed M.R. did, however, go on to guard himself against saying that whenever you find a covenantor in favour of a charity getting allowed to him certain privileges it therefore follows that such a covenantor no longer can say that he has paid without conditions or counter-stipulations. With this guarding statement I wholeheartedly agree, but the wider proposition has been advanced by the Crown that payments to a charity are disqualified for relief unless they are made as "pure bounty". Like Buckley J. in this case, I cannot accept this argument. It is not uncommon for inducements to be offered in order to support appeals for charity, as we are all aware; and for my part I feel I cannot go so far as Lord Denning M.R. in saying by way of illustration[2]:

> "Suppose a man gives a covenant for seven years to his old school, and in return there is a private understanding that his son, who is a dunce, will be given a place. The sum payable under the covenant does not qualify as an 'annual payment' ".

On the second question, whether the sum of £21,900 has been applied for charitable purposes only, I am in agreement with your Lordships and with Buckley J. that it was so applied. It is said on behalf of the Crown that there was a dual purpose: one charitable, an educational trust, the other non-charitable, to give a fair price for the assets of Tutors; the second purpose being non-charitable, the sums were not applied for charitable purposes only. It is said that it would be otherwise if the trustees had a pure choice, but since their choice was limited to Tutors alone the purpose was not charitable only. Further, it was maintained that a "fair price" is not good enough, for there should be, in order to be charitable, an obligation to obtain the school at the "best price". There is no suggestion of impropriety on the part of the trustees, and I do not find these objections to be valid. It would, of course,

(1) 34 T.C. 293, at p. 324. (2) *See* page 447 *ante*.

(Lord Hodson)

be otherwise if the obligation were to pay an inflated price, but that is not the case here, and I agree with the learned Judge that the fact that an incidental benefit was conferred on Tutors is not a disqualifying factor. A

Salmon L.J. took the view that the value of £50,000 for goodwill alone was not justified, but I think the arrangement cannot be attacked legitimately on that ground, seeing that the purchase of goodwill was linked with the prospective purchase of the other assets of the business. B

I would therefore dismiss the appeal.

Lord Guest—My Lords, I have had the advantage of reading the speech of my noble and learned friend Lord Hodson. I agree with it, and have only a few observations to make.

The Court of Appeal rejected the Appellants' claim on the ground that the "private understanding" between Tutors and the trustees that the sums paid by Tutors to the trustees would be used for the purchase of the business prevented the payments from being "annual payments" within the meaning of s. 169 of the Income Tax Act 1952. I am not prepared to go that length with the Court of Appeal and hold that a condition or stipulation of a non-contractual nature is sufficient to deprive an otherwise valid annual payment of its validity under this section. This approach of the Court of Appeal would appear to have been influenced by observations of Lord Evershed M.R. in *Commissioners of Inland Revenue* v. *National Book League* 37 T.C. 455 (at page 470), where he relied on certain dicta of Lord Normand in *Commissioners of Inland Revenue* v. *Corporation of London* (*as Conservators of Epping Forest*) 34 T.C. 293 (at page 324) to this effect: C D

> "The sum, in my opinion, is in no different position from a sum (having the requisite quality of recurrence) paid without conditions or counter-stipulations out of taxed income under a covenant by a private individual to any charitable body. The Crown would neither admit nor deny that such a payment would be an annual payment to the charity within the meaning of Case III, or that the party paying it would be entitled to retain the tax, or that the charity would be entitled to recover it. We were implored to be guarded in our opinions on covenants in favour of charities. I can only say that I am compelled to follow where the argument leads. If the payment under covenant were made by an individual to a body not a charity it could still be an annual payment, but the question whether it was in return for some consideration would probably be much more prominent and acute. If it were an annual payment the payer would be entitled to deduct tax under Rule 19(1) but the payee would not be entitled to recover the tax." E F G

Morris L.J. in the *National Book League* case(2) expressed the test as whether the payments were "pure income profit" in the hands of the charity. It is apposite to note that Lord Normand did not say that if the payment was made with a condition or stipulation of a non-contractural character the payment would not be an annual payment. I can see no ground or reason or authority why there should be such a narrow construction of "annual payment" in s. 169. For these reasons I conclude that the *ratio* of the decision of the Court of Appeal was not well founded. H

Buckley J.(3), [1966] 2 W.L.R., at page 1448, found that there was a contractual obligation on the trustees to pay the sums payable under the I

(1) Income Tax Act 1918, General Rules, r. 19. (2) 37 T.C., at p. 475.
(3) *See* page 447 *ante*.

deed of covenant to Tutors as instalments of the purchase price of Davies's. In my view this is the proper inference to be drawn from the findings of the Commissioners. In fact, I consider that the Commissioners specifically so found when they held:

> "This understanding that the covenanted payments would be so used seems to us, and we so hold, to be a condition or counter-stipulation attached to the deed of covenant."

There was at any rate evidence upon which they could so find, and I am not willing to disturb that finding. Buckley J. did not find himself able to hold that this contractual obligation was sufficient to deprive the payments of their character as annual payments under the section. In this I think he was wrong. If there was a legally enforceable obligation on the trustees, which I think there was, then the sums do not, in my view, qualify as "annual payments". As Mr. Goulding, for the Crown, so happily expressed it, "there must be a transfer of title to the income". If *unico contextu* with the alleged transfer there is a contract to pay it back on the purchase of the business, then there is no transfer of title to the income and, therefore, no annual payment.

In the view which I hold it is unnecessary to discuss the further question, which does not arise, whether the income was applied for charitable purposes only under s. 447 of the Income Tax Act 1952.

I would dismiss the appeal.

Lord Upjohn—My Lords, the facts of this case and the issues between the parties have been so fully and sufficiently stated by Viscount Dilhorne in his speech, which I have had an opportunity of reading, that I shall not restate either the facts or the issues but will at once proceed to examine the legal inferences to be drawn from the primary facts and then consider the legal issues.

It was plainly understood between the parties that the covenanted annual sums of 80 per cent. of the profits of Tutors to be paid to the Appellants, the Trustees of Davies's Educational Trust, were to be repaid to Tutors in purchase of Tutors' business. It was strenuously argued that the use of the word "understood" or "understanding" denoted a transaction binding in honour only. This argument is based on a fallacy. When persons enter into a business arrangement, as this certainly was, the presumption is that they intend that their business arrangements shall be legally enforceable, but of course the language that the parties have employed, whether oral or written, may shew, either expressly or as a matter of the proper inference to be drawn from their language and of all the relevant circumstances, that they did not intend their arrangements to be legally enforceable. The word "understanding", no more and no less than the word "agreement", is appropriate to express a legally binding agreement. Thus, if A agrees to do something on the understanding —another equally familiar phrase is "on the footing"—that another party will do something else, that is *prima facie* evidence of a legally binding agreement unless the rest of the language used or the surrounding circumstances point to a different conclusion. In this case the Special Commissioners used the word "understanding" in the sense "that the covenanted payments would be so used seems to us, and we so hold, to be a condition or counter-stipulation attached to the deed of covenant." As Counsel for the Appellants admitted, such last-mentioned words are terms of art properly applicable to express a relationship binding in law, and it seems to me quite clear that the finding of the Special Commissioners was a finding that the arrangement made between Tutors and the trustees in March 1961 was binding in law. Thus,

(Lord Upjohn)

your Lordships are relieved of the difficult question that might otherwise arise as to the position if the agreement had been binding in honour only. A

Then it was argued that you must look at and construe the documents executed by the parties to carry out their intentions, when it would be quite clear that, having regard to the terms of the partnership agreement of 5th April 1962 between Tutors and Developments, Developments were only bound to purchase a one-fifth share of the goodwill of Tutors; purchase of the remaining goodwill and of the freehold and leasehold premises was optional. So it was argued that the trustees were not bound to do more than purchase a one-fifth share of the goodwill and were free to spend the covenanted payments in, for example, the purchase of other educational establishments. No doubt, when parties enter into agreements which are subsequently carried out by more formal documents, usually the parties intend or are presumed to intend that the later and more formal documents contain and express their final agreement and supersede the earlier agreements, but in this case it is clear that the parties did not so intend. The basic agreement or (legally binding) understanding was reached between Tutors and the trustees in March 1961. The details were left to the fertile mind of Mr. Barber, the accountant, to carry out, but it is quite clear that the incorporation of Developments and the subsequent partnership deed between Developments and Tutors did not supersede the basic agreement. It was said that Tutors could not specifically enforce against Developments the agreement to purchase more than a one-fifth share of the goodwill of Tutors, and that is no doubt right, but this argument wholly overlooks the fact that it is quite clear that Tutors could have obtained a specific performance order against the trustees compelling them to procure Developments to purchase the remaining goodwill and other assets of Tutors with the money paid to them under the covenant. My Lords, I have used the words "with the money". I do so, not as identifying a particular receipt to be identified with a particular outgoing, but colloquially as expressing the view that a credit is received under the covenant by the trustees: the trustees must in due course in terms of their agreement provide Tutors with an equivalent credit as part payment of the assets of Tutors. So your Lordships are presented with a neat tax problem. B C D E F

Tutors covenant to pay each year a sum equal to 80 per cent. of their profits to the trustees. The trustees are bound to apply that sum in account year by year, broadly speaking, to the purchase of the assets of Tutors; the intervention of Developments (apart from the argument I have already noticed) may by common consent of the parties be ignored. Can this annual recurring payment properly be regarded as an "other annual payment" for the purposes of s. 169(1) of the Income Tax Act 1952, Schedule D, Case III? I do not set out the section, which is quoted in full by Lord Dilhorne. It is not in dispute that the annual payment by Tutors has been paid wholly out of profits or gains brought into charge to tax. G

This section (or its predecessors, which go back to 1842 or earlier) has been the subject of much judicial decision. These decisions shew that, apart from some broad principles, it is not possible to propound judicially what is an "other annual payment", a task upon which the Legislature has refused to give any guidance. Reading the section itself, it appears clearly that this "other annual payment" need not be one of pure bounty (a matter to which I must return later); on the contrary, it is linked with interest normally the result of contract, and read with subs. (2) it seems that the interest, annuity or annual payment may be payable as a personal debt or obligation by virtue of any contract. But some broad principles have been laid down. Thus, it is well settled that tax cannot be deducted by the payer in respect of payments which in the hands of the recipient are gross receipts for advice or services rendered H I

A or goods supplied, which merely form an element in discovering what the profits of the recipient are: *Earl Howe* v. *Commissioners of Inland Revenue* 7 T.C. 289; In re *Hanbury* 38 T.C. 588. In the last-mentioned case Sir Wilfrid Greene M.R. said(1)—and Lord Dilhorne has quoted it in full—that there was a class of annual payments which the Acts regard and treat as being pure income profit of the recipient undiminished by any deduction. Lord Normand B in the *Epping Forest* case(2), to which I must later refer, preferred Greene M.R.'s statement without the words "pure profit", and I agree with him. "Pure profit" had no relation to "pure bounty", and what Greene M.R. was stressing was that the payer could only deduct tax if, as between payer and payee, the annual payment would be (and I now quote his words as amended by Lord Normand) "income of the recipient undiminished by any deductions"—in C other words, by whatever method of assessment or collection the Act laid down, would be subject to tax without deduction. But there are many cases to which the phrase "annual payments" could be applied but which plainly do not fall within Case III of Schedule D: thus, income which without any deduction relevant for tax purposes may be assessed upon and collected from the payee under other Cases of Schedule D or under other Schedules (e.g. D wages or salary). So no principle can be laid down nor definition made of "other annual payment" in Case III nor under s. 447(1).

I think it is helpful at this stage to consider the philosophy behind the scheme of collection of tax under Case III where annual payments subject to tax without deduction in the hands of the recipient are made. For the purposes of income tax the payer is regarded as having parted with that part of his E income which by covenant or contract he pays away. The income that he pays away is that of the payee, and so he is entitled to deduct tax on paying it. These well-known general principles were explained in chapter 6 of the Radcliffe Report on the Taxation of Profits and Income(3) and by Lord Radcliffe himself in *Commissioners of Inland Revenue* v. *Frere*(4) 42 T.C. 125, at page 148. This general philosophy upon the machinery of the Income Tax Acts cannot, F however, really do more than supplement the proper judicial approach to this problem.

For my part I cannot see how in this particular case—and I am anxious not to lay down any general principles—the covenanted payments which have to be remitted by the payer to the payee by reason of an antecedent contract between the very same payee and payer, so that the payee is bound to G purchase the business of the payer, can possibly be regarded as income of the payee. Your Lordships are, of course, dealing only with questions of tax. It may well be that the trustees can spend that sum upon its receipt upon other proper items of alternative expenditure, and I do not accept the view of Salmon L.J., and possibly an alternative view of Buckley J., that these annual payments become subject to a trust in favour of Tutors. If that was the legally H correct answer then *cadit quaestio*: these payments in law never ceased to be income of Tutors nor ever became income of the trustees, and it is elementary that if you do not establish a trust in law you cannot do so for income tax purposes unless the taxing Act deems a trust in the most express and explicit terms. But for the purpose of tax—and rejecting any idea of trust on the facts of this case—I, for my part, am of opinion that it cannot be contended success- I fully that these covenanted payments can be comprehended in the phrase "other annual payment" for the purposes of Case III so that Tutors were entitled to deduct tax in making the payment. That perhaps is a matter of minor importance, for it affects only the rights and liabilities of Tutors and

(1) 38 T.C., at p. 590. (2) 34 T.C. 293, at p. 320.
(3) (1955) Cmd. 9474. (4) [1965] A.C. 402.

(Lord Upjohn)

the trustees *inter se*. But more relevantly, in my opinion, these annual payments cannot be regarded, upon the facts of this particular case, as annual payments forming part of the income of the trustees for the purposes of s. 447(1)(*b*). During the hearing before the Commissioners the trustees made some admission about the character of the advance made by the trustees to Developments; but that was, for all relevant purposes, very vague and ambiguous, and the role played by Developments so ephemeral that it cannot, in my opinion, affect your Lordships' decision upon this matter in any way.

My Lords, I agree broadly with the reasoning of Buckley J. in his judgment upon this matter, the relevant parts of which are set out in the speech of Lord Dilhorne, and with the noble Lord's own conclusion upon the matter. This annual payment for tax purposes never was income of the trustees. I only desire to add that I do not think it was necessary to the reasoning and conclusions of Buckley J. that he should equate the receipt of this annual sum to the purchase of a capital asset. The whole point is that it was a fundamental term of the agreement between payer and payee that these annual sums should be repaid without deduction to the payer. But I must not be understood as laying down any general principle in stating that; every case must depend upon its own particular facts and circumstances.

The Court of Appeal upheld the decision of Buckley J., but for different reasons. In truth they held that the "annual payment" must be "pure bounty" and that the covenanted payment in this case, being of course accompanied by a counter-stipulation, was therefore disqualified under s. 447. The Court of Appeal were led into this error by the reasoning of the same Court in the *National Book League* case([1]) [1957] Ch. 488 (a case rightly decided on the *Earl Howe*([2]) principle), who misunderstood what Lord Normand said in the *Epping Forest* case 34 T.C. 293. Because Lord Normand, in your Lordships' House, said([3]) of the annual payment that it was "no different from a sum . . . paid without conditions or counter-stipulations out of taxed income", the Court of Appeal in the *National Book League* case wrongly understood it to be a necessary condition to satisfy the section that an "annual payment" must be paid without any such conditions or counter-stipulations, in other words, in effect, pure bounty. It is quite clear that Lord Normand never intended his words to be so understood. Lord Cohen, in your Lordships' House, in a speech with which all of their Lordships agreed, explained what Lord Normand meant: *British Commonwealth International Newsfilm Agency Ltd.* v. *Mahany*([4]) 40 T.C. 550, at page 582.

My Lords, I have already examined, though briefly, the relevant text of the Income Tax Act, which is entirely contrary to any idea that an annual payment for the relevant statutory purposes must be pure income bounty. So I need not notice the argument advanced before your Lordships that in fact the covenant was pure income bounty, though I feel bound to say that I think this argument was unrealistic.

My Lords, the second question, whether the moneys received by the trustees were applied to charitable purposes, does not arise; but I entirely agree with the opinion expressed by my noble and learned friend Lord Dilhorne, and desire to add nothing thereto.

For these reasons I would dismiss this appeal.

Lord Donovan—My Lords, the root question in this case is whether the moneys paid under the deed of covenant were income in the hands of the

([1]) 37 T.C. 455. ([2]) 7 T.C. 289. ([3]) 34 T.C., at p. 324. ([4]) [1963] 1 W.L.R. 69.

A charitable trustees. The deed itself does not answer this question. The recital that Tutors desired to apply their profits to charitable purposes is equivocal. The covenant itself is simply to pay an annual sum to the trustees, the amount of which is measured by Tutors' profits. Familiarity with deeds of covenant of this sort fosters an initial assumption, perhaps, that what is being provided is an annual income; but if Tutors had specifically desired to provide the trustees B with a capital sum payable by seven yearly instalments the deed of covenant as drafted would have served that purpose equally well. One must look, therefore, to other evidence to solve the problem. One then finds that Tutors wanted the trustees to buy Tutors' business and to do so with money which Tutors would themselves provide. They came to a clear understanding with the trustees that the trustees would use the money so provided for this purpose C and for no other; and I agree with your Lordships that in the circumstances of this case the understanding would have been enforceable in contract. One therefore has a case where a person wishing to sell an asset provides the prospective purchaser with the purchase price. That seems to me as clear a case of a gift of capital as one could want. No contradiction of the terms of the deed of covenant are involved in this conclusion. Those terms do not D stamp the gift as one of income.

This is the decision at which Buckley J. arrived. He does not say, as appears to be suggested by Lord Denning M.R., that the payments were capital simply because they were applied to the purchase of a capital asset. That notion is (as one would expect) expressly disclaimed by Buckley J. His view was that they were capital receipts when the trustees received them, and I agree. E This is enough to dispose of the case.

Had the sums been truly income in the hands of the trustees, the question whether it made any difference to their right to recover income tax that they were bound to apply that income to purchasing the business from the donor would have become crucial. Since the point may arise in some future case, I say no more about it, except that the Court of Appeal came to its decision by F reasoning from which I respectfully dissent. Its judgment is based on certain views of what constitutes an "annual payment" within the meaning of Case III of Schedule D which, if correct, would have an effect well beyond the limits of the present case. They were supported (though on occasions with some difficulty) by the Crown before your Lordships; and we were told by Counsel for the Appellants that, in consequence of the same views, he understood that G claims for repayments of tax by other charities which had hitherto been allowed were now being held up. It is desirable, therefore, to deal with the matter.

It was said below that there cannot be an "annual payment" within the meaning of Case III of Schedule D if the recipient has to "give or do anything in return for the payment"; or if there is a "counter-benefit" to the covenantor; H or if the covenantor should "make conditions or stipulations"; or unless the payments are "pure bounty". These statements contradict the charging words of Case III of Schedule D itself, which envisage that an annual payment may be payable "by virtue of any contract", and that therefore the recipient may have to give or do something in return for the payment, which will not in such circumstances be "pure bounty" in his hands. One obvious example is the I annuity purchased from an insurance company. The Court of Appeal relied on certain words used by Lord Normand in *Commissioners of Inland Revenue* v. *Corporation of London* (*as Conservators of Epping Forest*) 34 T.C. 293. He said, towards the end of his long and close analysis of the facts in that case(1),

(1) 34 T.C., at p. 324.

(Lord Donovan)

that the payment there in question was "in no different position from a sum (having the requisite quality of recurrence) paid without conditions or counter-stipulations out of taxed income under a covenant by a private individual to any charitable body." It clearly does not follow from this passage that *every* condition or counter-stipulation in such a covenant takes the payment outside Case III of Schedule D. The test of an "annual payment" within that Case is the same whether the recipient is a charity or not; and, reading Lord Normand's speech as a whole, I think that he is using the expression "condition or counter-stipulation" as a convenient general description of that type of payment which Scrutton L.J. said in *Earl Howe* v. *Commissioners of Inland Revenue* 7 T.C. 289 would not be an "annual payment" from which tax could be deducted, i.e., annual payments for goods or services. Lord Evershed M.R. also relied to some extent on Lord Normand's words when giving judgment in *Commissioners of Inland Revenue* v. *National Book League* 37 T.C. 455. In that case, however, the evidence clearly established that the so-called "annual payment" was simply a club subscription in return, as the Crown contended, for "the annual provision by the League of goods and services", and so was clearly within the scope of the decision in *Earl Howe's* case.

Apart from the purchase of an annuity instances are not lacking where the payer receives a counter-benefit or makes some counter-stipulation, and yet the sum he pays is an annual payment within Case III in the hands of the recipient. For example, the right to use a secret process may be acquired, the purchaser agreeing to pay an annual sum during all the years of user: *Delage* v. *Nugget Polish Co. Ltd.* (1905) 21 T.L.R. 544. An employee of a film company may give up all his existing rights to remuneration in return for a percentage of the takings of certain films: *Asher* v. *London Film Productions Ltd.* [1944] K.B. 133. And I respectfully think that the case instanced by Lord Denning M.R., where a parent covenants to pay a school an annual sum if the school will accept his backward son as a pupil at the full fees, is another instance where such annual payment *would* fall within Case III. Another example quoted by the Master of the Rolls is that of a father who covenants to pay his adult son £400 a year with a private understanding that the son should return part of it to his father. He says that this would nullify the covenant for tax purposes and that the sum paid by the father would not be an "annual payment". I am not at all sure that this would be so. So far as the father's total income for surtax purposes in concerned, it might well be treated as diminished only by the difference between £400 and the sum returned to him, but at least by that. So far as the son's liability to tax is concerned, I should have thought that he would be liable to suffer tax, whether by deduction at source or otherwise, on the whole £400 as an annual payment under Case III, and that he could claim no deduction for the part returned under the private understanding. This is not a problem, however, which calls for decision in the present case. Finally, on this point one may refer to *Duke of Westminster* v. *Commissioners of Inland Revenue*[1] 19 T.C. 490. There Lord Macmillan thought that there was an enforceable counter-stipulation by the servant that in return for the annuity he would work for lower wages. Yet the whole sum paid by the Duke under his covenant was treated as an annual payment; and although the argument in the case proceeded on different lines, I cannot think that if a counter-stipulation, or the absence of "pure bounty", had the effect of taking the annual payment outside Case III, this short answer to the Duke's case would have escaped Lord Macmillan. Lord Russell and Lord Wright also thought that, if Lord Macmillan's views were right, the result of the case would still have been the same.

(1) [1936] A.C. 1.

A The truth is, in my opinion, that one cannot resolve the problem whether a payment is an annual payment within Case III simply by asking the questions "Must the payee give or do something in return?" or "Did the payer make some counter-stipulation or receive some counter-benefit?" or "Was it pure bounty on his part?" Such questions come more easily to the mind perhaps where, as here, payment to a charity is involved. But there is no warrant in the B Income Tax Acts for applying a special test in the case of charities. The test must be applicable to all annual payments; and the problem must continue to be resolved, in my opinion, on the lines laid down by Scrutton L.J. in *Earl Howe's* case(1). One must determine, in the light of all the relevant facts, whether the payment is a taxable receipt in the hands of the recipient without any deduction for expenses or the like—whether it is, in other words "pure in- C come" or "pure profit income" in his hands, as those expressions have been used in the decided cases. If so, it will be an annual payment under Case III. If, on the other hand, it is simply gross revenue in the recipient's hands, out of which a taxable income will emerge only after his outgoings have been deducted, then the payment is not such an annual payment. This, of course, has been said often enough before, but the judgment under review makes it necessary, I D think, to say it again. The test makes it necessary to decide each case on its own facts. If goods and services are supplied in return for the payments in question, no doubt it will normally be found that this is done continuously or periodically during the time that the sums are payable, though there may be exceptions to this situation.

I would dismiss the present appeal for the reason stated at the commence- E ment of this opinion, namely, that the trustees received the relevant sums as capital. This makes it unnecessary to decide whether they were applied for charitable purposes only, though I think they were.

Questions put:

That the Order appealed from be reversed.

The Not Contents have it.

F That the Order appealed from be affirmed and the appeal dismissed with costs.

The Contents have it.

[Solicitors:—J. S. Fairfax-Jones; Solicitor of Inland Revenue.]

---

(1) 7 T.C. 289.