

1960 Present : Sansoni, J., and H. N. G. Fernando, J.

COMMISSIONER OF INCOME TAX, Appellant, and J. COWASJEE
NILGIRIYA, Respondent

S. C. 2—Income Tax Case Stated BRA/260

Income tax—Statutory income—Permitted deductions—“ Annuity ”—“ Expenditure of a capital nature ”—Income Tax Ordinance, ss. 10, 11, 13 (1) (a)—Profit Tax Act.

On the death of one of two partners who carried on a partnership business the surviving partner entered into an agreement with the widow of the deceased for the purchase by him of the deceased's share of the goodwill of the business for the sum of Rs. 106,000. In regard to the amount payable, one clause of the agreement provided that the purchaser should pay to the vendor £ 50 per month for life. But this clause was made subject to certain other clauses which provided not for the payment of an “ annuity ” but instead for monthly instalments of £ 50 which in the aggregate would in one event amount almost exactly to the fixed gross sum of Rs. 106,000, subject to the arrangement that in certain other events the fixed gross sum would be abated to a lesser sum, the amount of which would be the aggregate of the instalments payable under the Agreement for the period ending with the time of the occurrence of any such event.

Held, that the payment of £ 50 a month, being of a capital nature, was not an “ annuity ” within the contemplation of section 13 (1) (a) of the Income Tax Ordinance. The purchaser, therefore, was not entitled to deduct it from his statutory income.

CASE stated under the Income Tax Ordinance.

M. Tiruchelvam, Q.C., with *H. L. de Silva*, Crown Counsel, and *K. Thevarajah*, for assessor-appellant.

H. W. Jayewardene, Q.C., with *K. Sivagurunathan* and *C. P. Fernando*, for assessee-respondent.

Cur. adv. vult.

November 23, 1960. H. N. G. FERNANDO, J.—

The respondent-assessee was formerly a partner, together with one Reid, in a Firm of Architects. Reid died on 21st March, 1952, and in terms of the partnership agreements the respondent had the option to purchase the share of his deceased partner in the partnership business and the goodwill on payment to the deceased's legal representative :—

- (1) of certain sums due to the deceased by way of prior profits and debts, and

(2) of the value of the deceased's share of the goodwill together with interest at 5 per cent. on such value, the agreements having provided that the value of the goodwill shall be taken to be a sum equal to "one year's purchase of the annual gross earnings" of the last completed year of the partnership.

The option was duly exercised by the petitioner, who entered into a further Agreement in August 1953 with the deceased's widow in regard to the purchase of the deceased's said interests. Clause D of the Recitals in this Agreement stated :—

firstly that the net amount due from the purchaser (the respondent) as the sums to which I have referred at (1) above is Rs. 103,372·78, and *secondly* that the amount to be paid in respect of goodwill is Rs. 106,000, "although such sum does not represent the value of the goodwill calculated according to the provisions of the said deed of partnership".

Clause E of the Recitals stated that the parties had mutually agreed that the aforesaid sums shall not be paid within the time and according to the provisions of the said deed of partnership, but that "in lieu thereof, the liability of the Purchaser to the Vendor shall be discharged at the times and subject to the terms and conditions hereinafter set forth". In the operative Clause 2, the purchaser agreed to pay firstly the sum of Rs. 103,000 odd, and secondly the sum of Rs. 106,000 in satisfaction of the vendor's share of the goodwill, "subject however to adjustment or settlement or abatement in manner hereinafter provided".

In respect of the first sum, which included a debt of Rs. 20,000 with interest at 5 per cent. which had previously been owed to the deceased by the Firm, the Agreement provided for its payment in instalments out of a reserve to be built up out of the annual net profits, each annual instalment to be not less than Rs. 10,000. But while interest at the same rate was to be payable on the Rs. 20,000, it was expressly agreed that no interest would be payable on the balance sum of Rs. 83,000 odd, there being in this case a clear waiver by the widow of her right to interest on this sum which became due to her as a debt by reason of the purchase of the deceased's interests.

In respect of the second sum, the parties in effect agreed not to follow the basis of valuation of goodwill specified in the partnership deeds, and also not to observe the mode of payment there specified, namely that the value of the goodwill was to be paid in full in a lump sum, or else together with interest at the rate of six per centum. The new provisions in the 1953 Agreement in regard to payment for the goodwill can be summarised thus :—

Clause 6. "In respect of the amount payable in respect of the deceased's share of the goodwill, the purchaser hereby agrees to pay from 30th April, 1952, £50 per month to the vendor for life". But this clause was made subject to certain other clauses.

Clause 8. The monthly payments were at the latest to cease on 31st March, 1965, even if the deceased's widow survived thereafter. Hence the maximum amount of the purchaser's liability would be £ 50 a month for 13 years, i.e. £ 7,800, or (at the rate of Rs. 13·50 to the £) a sum of Rs. 105,300.

Clause 9. If, at any time after April 1957, the continuing Firm ceased to carry on business or the purchaser ceased to be a partner thereof, in either event for reasons beyond the purchaser's control, the liability to make the monthly payments would terminate at such time of cessation, but in the case of any earlier cessation the monthly payments had nevertheless to be made for the first five years 1952-1957.

Clause 7. Although the monthly payments were in clause 6 stated to be payable during the life of the widow, nevertheless clause 7 created a liability to make the payments until 31st March, 1957, to her legal representatives in the event of her earlier death. The effect of clauses 7 and 9 together was to create an unconditional liability for the five years 1952-1957.

Section 10 of the Income Tax Ordinance provides that in ascertaining the profits or income of any person from any source no deductions shall be allowed in respect of—

- “ (c) any expenditure of a capital nature or any loss of capital ;
- (i) any annuity, ground rent or royalty ”.

The income from each source, without the deductions prohibited by section 10, is declared by section 11 to be the statutory income from that source for the succeeding year of assessment. Section 13 then declares that the total statutory income less any permitted deductions to which I will immediately refer, shall be the assessable income for purposes of taxation. One such permitted deduction is :—

- “ (a) any sums payable by him for the preceding year by way of
 annuity ” .

The substantial effect of the corresponding provisions in the Profit Tax Act is the same as those of the Income Tax Ordinance to which I have referred. If therefore the payment of £ 50 per month by the respondent to the widow of Reid is an “ annuity ” within the contemplation of section 13 (1) (a), then the purchaser would be entitled to deduct it from his statutory income and his income for purposes of taxation under each of the enactments would become considerably reduced.

The respondent's claim to make this deduction was disallowed by the authorised Adjudicator in a determination which fully sets out the relevant terms of the Agreement which was required to be construed and the reasons which moved the Adjudicator to reach his finding. On appeal to the Board of Review the finding was reversed in a decision

which gives little or no clue to the grounds for the opinion formed by the Board. Considering that the Board did reverse a full and reasoned determination of the Adjudicator, and that there is statutory provision for appeals to this Court from decisions of the Board of Review by way of case stated, many of which appeals have in fact been preferred and some of them taken further to the Judicial Committee of the Privy Council, it is unfortunate that in the present case the review of the Board's decision by this Court had to be undertaken without knowledge of the reasons moving the Board of Review.

Counsel on both sides have referred to English and Indian decisions and counsel for the respondent examined during the argument a series of English decisions commencing with the early case of *Lady Foley v. Fletcher*¹, decided in 1858, and ending with the 1940 decision in *Southern-Smith v. Clancy*². The general observations made in many of those judgments are pertinent to the consideration of the questions I have to decide, and they were substantially to the following effect:—Their Lordships of the Privy Council in *1935 A. I. R. (P. C.) 143 at page 146* said this :

“ They content themselves with repeating the view expressed in the judgment of the Board above referred to that little can be gained by trying to construe an Income Tax Act of one country in the light of a decision upon the meaning of the Income Tax Legislation of another ”.

In *Southern-Smith v. Clancy*, Goddard, L.J. (as he then was) said :

“ The only principle which I can deduce from the cases is that the Court must have regard to the true nature of the transaction from which the annual payment arises and must ascertain whether or not it is the purchase of an annual income in return for the surrender of capital. If it is the purchase of an income, it is taxable. If it is a capital payment, it is not ”.

While bearing these general observations in mind, I propose to cite only one of the passages upon which counsel for the appellant relied, for it is substantially similar to other expressions of opinion which counsel thought to be favourable to his case. In *Chadwick v. Pearl Life Insurance Company*³ Walton J. stated the principle, which he thought to be applicable, as follows :

“ In the one case there is an agreement for good consideration to pay a fixed gross amount and to pay it by instalments ; in the other there is an agreement for good consideration not to pay any fixed gross amount, but to make a certain, or it may be an uncertain, number of annual payments. The distinction is a fine one and seems to depend on whether the agreement between the parties involves an obligation to pay a fixed gross sum ”.

¹ 157 *English Reports* 682.

² (1941) 1 *A. E. R.* 111.

³ (1905) 2 *K. B.* 507.

Referring to the terms in which the distinction was drawn, Scott L.J., in *Dott v. Browne*¹, observed that Walton J.'s language illustrated the "danger of taking a particular sign-post as having more meaning than a mere sign-post", and demonstrated by examples that an agreement can provide for the payment by instalments of a debt, notwithstanding that the amount of the debt may not be a fixed gross sum specified in the agreement. But for present purposes I can assume (without agreeing) that the proper "sign-post" to an agreement to repay capital by instalments is "the obligation to pay a fixed gross sum".

It is not difficult to reach the conclusion that the Agreement between the respondent and Mrs. Reid (examined in the light of the formula just cited) contemplated the payment of a debt in monthly instalments. Indeed there is every indication that, because the terms of clause 6 of the Agreement "£ 50 per month for life" might mislead the reader into the impression that here was a true annuity, particular care was taken by the draftsman to correct such a possible misconception. I can best explain the reasons for my construction of the Agreement by pointing to the indications of that care which I find in it.

- (a) The deed of partnership provided a clear basis for the valuation of the deceased's interest in the goodwill, i.e. the basis of one year's gross earnings, and when the Agreement was signed in August 1953, there should have been no difficulty whatever in ascertaining on this basis the gross earnings for the completed year prior to Reid's death in March 1952. Nevertheless the Agreement fixes the value of the goodwill at Rs. 106,000, expressly stating that it had not been calculated in terms of the deed of partnership. Had the valuation been made on the prescribed basis, and had it then been impossible to "quantify" the instalments of £ 50 per month as representing payment of the amount of the valuation plus interest, then one might be forced to conclude that the sum ascertained by valuation had ceased to exist and that what remained was the liability of the respondent to pay an annuity. Instead, the value was agreed at Rs. 106,000, but not according to the prescribed basis of valuation; and it is in my opinion relevant and necessary to inquire why this sum was fixed. One of the contemplated events was that Mrs. Reid may survive until 1965 or later; and for that event, the Agreement provides for total payments amounting to £ 7,800 which at the rough rate of exchange often adopted (Rs. 13·50 per £) is the equivalent of Rs. 105,300. It is most difficult to resist the construction that the fixation of Rs. 106,000 was made in contemplation of such an event. This event, that the payments would continue until 1965, was surely the most favourable event which each of the parties could have had in contemplation: Mrs. Reid, that she would

¹ (1936) 1 A. E. R. at page 550.

attain ripe old age ; the respondent, that, unless unavoidable circumstances intervened, he would carry on for many years the profitable business he was acquiring for himself.

- (b) There is then the phraseology of clause 6 itself. Subject to clauses 7, 8, 9 and 10, the sum of £ 50 per month is to be payable for life “ in respect of the amount payable by the purchaser to the vendor ”. In other words, does not clause 6 clearly state that the payments to be made are *in respect of the sum of Rs. 106,000 earlier fixed* as due to Mrs. Reid, which payments would gradually reduce the total sum due ?
- (c) Although the partnership deed entitled Mrs. Reid to interest on the value of the goodwill, this right of hers was waived by the Agreement ; so that the question, whether the fixed monthly payment can or cannot be made referable to a repayment of the principal *and interest* on some reasonable basis, does not arise, and perhaps was deliberately not permitted to arise.
- (d) It is argued that as in the case of a genuine annuity there was here a risk that the original debt of Rs. 106,000 would probably not be repaid in full : that because the respondent had no funds in 1953 with which to repay the full debt, Mrs. Reid was satisfied to ensure for herself an income of £ 50 a month, with certainty for five years and with near certainty for a life enduring till 1965. Had that been her pre-occupation, the failure to make a proper valuation of goodwill and to state that the payments were to be made in consideration of the release of the respondent from his obligation to pay the sum so ascertained, is quite un-understandable. The stated consideration for the obligation to pay the annuity should surely have been the true one, and not the sum of Rs. 106,000 which in such an arrangement would have been arbitrary and meaningless. There is a much more acceptable explanation for the circumstance that the respondent might not under the Agreement ultimately have to pay a total sum of Rs. 106,000. Clause 2 of the Agreement recites that the parties had agreed to pay Rs. 106,000 “ subject to adjustment, settlement or abatement in manner hereinafter provided ”. In other words Mrs. Reid agreed that the fixed sum might be abated in specified events, one event being her death not later than March 1957, and another event being the inability of the respondent *for causes beyond his control* (clause 10), to continue as a partner in the business. This willingness to the abatement of the fixed sum seems to me nothing but a willingness to reduce the amount of the debt in those events.
- (e) Similar light is thrown on the intention of the parties in other clauses. By clause 7, if Mrs. Reid dies before 31st March, 1957, “ no further liability shall attach to the purchaser *to make further payments on account of the goodwill* ” : again in the event

of her surviving after 31st March, 1965, clause 8 contains a declaration in similar terms. If liability to make the monthly payment terminates in 1957 because the respondent ceases to be a partner in the Firm for reasons beyond his control, here too clause 10 provides that after 31st March, 1957, the respondent shall not be liable to pay any further sum *as against the said sum of Rs. 106,000*. In the language occurring in many of the dicta upon which counsel for the respondent relied, there was here no "disappearance" of the Rs. 106,000, nor did the sum "cease to exist". Instead the Agreement repeatedly stated both that the monthly payments were to be "in respect of" or "against" this sum, and also that in certain events further sums would not be payable against or in respect of this sum.

I would hold therefore that the Agreement provided not for the payment of an "annuity" but instead for monthly instalments of £ 50 which in the aggregate would in one event amount almost exactly to the fixed gross sum of Rs. 106,000, subject to the arrangement that in certain other events the fixed gross sum would be abated to a lesser sum, the amount of which would be the aggregate of the instalments payable under the Agreement for the period ending with the time of the occurrence of any such event. The monthly payments were accordingly of a capital nature, and the opinion of this Court on the questions stated for such opinion has to be that each of the questions 1-5 set out in the Stated Case have to be answered in the negative.

The respondent must pay to the appellant costs fixed at Rs. 525.

SANSONI, J.—I agree.

Appeal allowed.

