Sothern-smith Vs. Clancy.

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Court : Kolkata

Decided On : Dec-13-1940

Reported in : [1941]9ITR73(Cal)

Appellant : Sothern-smith

Respondent : Clancy.

Judgement :
Nov. 26, 27. Dec. 13, 1940.

GREENE, M R, stated the facts and continued : The case has throughout been conducted upon the footing that the respondent, although she was not a party to the contract, is entitled in law to claim from the society the sums which it is agreed to pay to her. It may be that this is in accordance with the law of the State of New York by which the contract would seem to be governed. The assessments were made under Case III of Schedule D, and the relevant provisions of the Income Tax Act, 1918, are as follows : 'Schedule D. 1. Tax under this Schedule shall be charged in respect of..... (b) All interest of money, annuities and other annual profits or gains not charged under Schedule A, B, C, or E and not specially exempted from tax.... for every twenty shillings of the annual amount of the profits or gains. 2. Tax under this Schedule shall be charged under the following cases respectively; that is to say..... Case III. Tax in respect of profits of an uncertain value and of other income described in the rules applicable to this Case;' 'Rules applicable to Case III, 1. The tax shall extend to - (a) .... any annuity or other annual payment whether such payment is payable within or out of the United

Kingdom.....' It is clear that an annuity or other annual payment falls to be struck with tax as being an 'annual profit or gain', and this is the reason why it becomes necessary to examine the nature of an annual payment in order to see whether it is in truth an income or a capital payment-a question which cannot be answered merely by pointing to the fact that it is annual. Questions of this kind are notoriously difficult and give rise to distinctions of a highly artificial character. The present case is no exception.

It is no doubt true to say that in order to answer the question the real nature of the transaction must be ascertained. This proposition has an engaging appearance of simplicity; but it is not so simple as it sounds. For the expression 'the real nature of the transaction' is ambiguous. It may mean the real nature of the legal relationship of the parties which results from the transaction - a matter which may not be in doubt; or it may include as well the real nature of the transaction from a financial point of view-a matter which at once raises a number of difficulties. If the transactions be one under which A, being or becoming indebted to B for a sum of pound 1,000, agrees with B to repay this sum by ten yearly instalments, or if A, being the purchaser of property from B for pound 1,000, agrees to pay the purchase price by ten yearly instalments, the real nature of the transaction from the legal point of view is that A is contracting to pay by instalments in the one case a debt and in the other a purchase price. In such cases the very nature of the legal relationship constituted by the contract prevents the annual payments from being anything but payments of capital. If to the instalments there is added an element of interest, that element would presumably attract tax as being an annual profit or gain. This would appear to be the result of Scoble v. Secretary of State in Council of India (1903) 4 Tax Cas. 618 and Perrin v. Dickson (1930) 14 Tax Cas. 608, although in Foley v. Fletcher (1858) 28 L.J. Ex 100; 3 H & N 769 the opposite view was expressed. But in other cases the real nature of the transaction from the legal point of view does not of necessity stamp it as a capital transaction. Let me take the simple case of a contract under which in consideration of a single payment by B, A agrees to pay to him an annuity for a period of years. The legal nature of such a contract is beyond question. The property in the said sum paid by B passes absolutely to A; no relationship of debtor and creditor with regard to that sum is ever constituted. The sum as a sum ceases to exist once it is paid. Its place is

taken by As promise to pay the annuity, and Bs only right is to demand payment of the annuity as it accrues due. If A repudiates the contract, B may sue for damages, the measure of damages being the sum of the payments still remaining to be paid, subject to discount. Is it then permissible to look behind the legal nature of the transaction and inquire into its financial nature If this is done, it is at once apparent that the annual payments are calculated on the basis that at the expiration of the period of the annuity B will have received an amount equal to the sum which he paid together with a sum in respect of interest, for it is on that basis that in such a transaction the amount of the annual payments is calculated. That this is so will be self-evident from the figures themselves. It may even be stated in terms. The financial result of the transactions is therefore clear : at the end of the period B will have received an amount equal to his capital, plus a certain addition for interest, and if each annual payment is struck with tax he will in one sense be paying tax on capital. Nevertheless, it has throughout been assumed by the Courts that such payments are liable to tax. (See for example Coltness Iron Co. v. Black (1881) 1 Tax Cas. 287, Jones v. Commissioners of Inland Revenue (1920) 7 Tax Cas. 310, and Perrin v. Dickson (1930) 14 Tax Cas. 608. The reasoning in Scobles Case (1903) 4 Tax Cas. 618 seems to be based upon the same view).

In Perrin v. Dickson (1930) 14 Tax Cas. 608, on the other hand, this Court felt itself at liberty to hear extrinsic evidence as to the method of calculating the payments which feel to be made, and upon the facts so ascertained, coupled with a particular term of the contract, to hold that they were of a capital nature. I must confess that I find the reasoning of the judgments in that case difficult to follow. In the events which happened the liability to make the annual payments became effective, and in that aspect of the matter the case did not differ from the ordinary case of the purchase of an annuity for a period of years. The method of calculating the annual sums was apparently regarded as of importance; but it can scarcely have been regarded as decisive, because the same method is used in the ordinary case of an annuity for a period of years, and Lawrence, L.J., at any rate did not regard himself as deciding that such an annuity would not be taxable. The other important element in the case was the undertaking of the insurance company to repay in an event which did not happen the whole or part (as the case might be) of what had been paid by way of premium. This seems to have led the Court to

regard the whole transaction as similar to that of a loan repayable by instalments or (in one event) in a lump sum. My difficulty here is that the transaction certainly was not a loan transaction, although I could better have understood an argument to the effect that it was a transaction which, in the event which did happen, was the purchase of an annuity and in the event which did not happen was in substance the repayment of the whole or part of what had been paid.

If the law were that in the ordinary case of an annuity for a term of years, the nature of the financial calculation involved stamped part of the payment as a capital payment, leaving only the interest element to be taxed, on the ground that an annuity is only taxable in so far as it is a profit, the position would be simple and perhaps not unjust. In truth there is a basic distinction between such an annuity and a life annuity, since in the latter case the sum of the payments which fall to be made may prove to be less or greater than the sum paid by the annuitant, while in the former case it will be the same as the amount paid together with an addition for interest. Upon this basis Perrins Case (1930) 14 Tax Cas. 608 would have been a clear one. But I do not feel myself at liberty in this Court to adopt any such principle. I feel bound to regard the purchase of an annuity of the kind to which I have referred as the purchase of an income and the whole of the income so purchased as a profit or gain notwithstanding the way in which the payments are calculated. The sum paid for the annuity has ceased to have any existence, and the fact that at the end of the annuity period the recipient will have received an amount equal at least to what he paid I feel bound to treat as irrelevant. Nor do I think it can make any difference if this result is stated on the face of the transaction. Perrins Case (1930) 14 Tax Cas. 608 decides at any rate that the absence of such a statement cannot prevent the annual sums paid being capital since extrinsic evidence was admitted : it appears to me to follow that the presence of such a statement cannot prevent them being income.

I need not set out in detail the terms of the present contract. It bears upon its face statements to the effect that the result of its operation will be that the annual payments made under it will in the aggregate amount at the least to the sum paid by Mr. Sothern, while if Mr. Sothern were to live long enough they would exceed it. But the contract is in reality a contract to pay an annual sum to him during his life,

with the added provision that in a certain event the payments will continue annually until an ascertainable date is reached, that date being fixed by reference to the amounts paid to him in this lifetime. In other words the contract is to pay an annual sum for an ascertainable period of years or for the period of Mr. Sotherns life whichever might prove to be the longer. There is no debt, nor is there anything which can properly be described as analogous to a debt. The sum paid by him has gone once for all. The reference to it in the contract is inserted not for the purpose of putting a term to a liability which is throughout the same, namely, a liability to pay an annual sum. During his life the sums paid to him were payments of a life annuity; in the events which have happened further annual payments fell to be made for a definite period, and the fact that this period was ascertained by reference to the capital sum paid by him and the amounts received by him during his life cannot, in my opinion, make these further payments anything different from the ordinary payments of an annuity for a fixed term. He purchased an income, and the capital amount which he paid only came into the matter for the purpose of defining the period during which that income was to be paid. I do not find anything in Perrins Case (1930) 14 Tax Cas. 608 which persuades or compels me to come to a different conclusion.

Lawrence, J., from whom I am respectfully differing, thought that the capital sum paid by Mr. Sothern never ceased to exist and that the contract in express terms guaranteed that the capital invested should be refunded or returned. I do not take this view. It seems to me that the capital sum did cease to exist once it was paid, and that the so called guarantee was an undertaking not to refund a capital sum or any part of a capital sum, but to continue annual payments for an ascertainable period. The view taken by Lawrence, J., would appear to lead to the result that every annuity payable for a period of years would escape taxation if it were pointed out upon the face of the contract that at the conclusion of the annual payments the annuitant would have received sums amounting in the aggregate to the sum or sums which he had paid for the annuity together with an allowance for interest. In my opinion the appeal should be allowed.

CLAUSON, L.J., after stating the facts outlined above, continued : The case for the Crown, which commended itself to the Special Commissioners, was that these

payments to Mrs. Sothern-Smith were taxable as annuities. For Mrs. Sothern-Smith it was contended (and this contention commended itself to Lawrence, J.) that the payments made to her were annual instalments of a fixed capital sum in respect of which the company became indebted to her, under the contract, on the death of the contracting party. It was not necessary to decide whether the payments made under the contract to Mr. Sothern during his life were chargeable to income-tax as annuities. From the wording of clause 9 in the Special Case I should gather that the Special Commissioners regarded all the annual sums payable under the contract as falling within the description of annuities and accordingly chargeable to income-tax. Lawrence, J., refrained from dealing with any question arising upon the sums paid by the company to the original contracting party.

Similar questions to the present have been before the Courts on many occasions, but the principles to be applied in considering whether in a particular case periodical payments are or are not chargeable to tax under the Acts are well established, though not always easily applicable to the particular circumstances. I do not propose to examine the earlier authorities, but merely to take the statement of these principles as enunciated in this Court in the case of Perrin v. Dickson (1930) 14 Tax Cas. 608. In delivering judgment in that case, P.O. Lawrence, L.J., after referring to Foley v. Fletcher (1858) 28 L.J. Ex. 100; 3 H. & N. 769 and Scobles Case (1903) 4 Tax Cas. 618 said this (98 L.J.K.B., at p. 689; [1930] 1 K.B., at p. 122; 14 Tax Cas., at p. 625); 'The principle upon which both these cases were decided is that it never was the intention of the Income Tax Acts to tax capital as if it were income, with the result that, even although a contract may provide for the payment of annual sums of fixed amount and may call such payments an annuity the Court will in each case inquire into the real nature of the transaction, and if it appears that in fact part of such sum represents payment of capital, such part will not be chargeable with income-tax. Both these cases, however, distinctly recognise that in the case of a simple purchase of an annuity in consideration of a money payment the full amount of the annuity is chargeable with income-tax. The distinction which is apparently drawn in these cases is between a purchase of an annuity for a fixed term in consideration of the payment of a sum of money, and a contract to pay an annuity in consideration of the

conveyance of land or other property.' As I understand P.O. Lawrence, L.J., there intended to point out that the annuity first mentioned will be chargeable to income-tax, while that secondly mentioned will not.

Applying to the present case this statement of the principles applicable, it appears to me that the only possible conclusion is that the payments made by the company under the contract are all taxable. It seems clear that if the contract had merely been to pay $ 6,510 for the number of years and the fraction of a year which were requisite for making up the total payments of $ 65,243, this would create a taxable annuity. The addition to such a contract of a further liability to pay the same nominal sum to the contracting party for the rest of his life if he should survive that period, can surely not alter the character of the payment, especially when it is borne in mind that no one has ever doubted that a contract to pay an annuity for a period measured by life, whether in consideration of a lump sum down, or a series of successive periodical payments (usually called premiums), must be taken to be an annuity chargeable to tax. The view I have expressed was, as I understand, the view taken by the Special Commissioners.

The first line of attack made on this position by counsel for the respondent was to argue boldly that the term 'annuity' in the Acts meant, and meant only, 'life annuity', and he pointed out that the present contract involved obligations on the company which were not terminated by the falling of a life, if the life fell before the period when the sums paid by the company reached the figure of the original cash consideration. It seems to me to be a sufficient answer that if 'annuity' in the Acts means life annuity there was a short and conclusive argument available both in Foley v. Fletcher (1858) 28 L.J. Ex. 100 : 3 H. & N. 769 and in Scobles Case (1903) 4 Tax Cas. 618 to defeat the claim that the periodical payments in those cases, which had no reference to life, were taxable as annuities, and the elaborate arguments in those two cases were superfluous and unnecessary. There was, however, a further and, if I may say so, far more plausible argument put forward, and it was as follows : It was said that if the premiums or the sum of the premiums paid by the so-called annuitant must, under the terms of the contract, in any event be returned to him, that circumstance must be taken to show that the transaction is not the purchase of an annuity but is a mere investment of capital money with the

company, to be repaid in due course with, in certain events, interest or other benefits. The payments made by the so-called annuitant were, it was said, capital of which it was not true to say that it ever has gone or has ceased to exist; it retained throughout its character of capital which passed away for a period from the so-called annuitant but was in due course returned to him; it was a mere loan to the company repayable on terms, and the sums paid (or rather, it was said, repaid) to the so-called annuitant were, to the extent of the sums paid by him, payments or rather repayments of capital. Any moneys in excess of that amount paid under the contract might well be profits and taxable.

In my judgment it is not possible to treat the present contract as one of mere investment. It will be observed that if the contracting party died before the time when the total amount of the $ 65,243 had come back to him or to those claiming under him in the form of annual payments, the net result would be that he and those claiming under him would have been out of the money for the period, roughly ten years, with no allowance of interest at all. That does not look much like an investment from the contracting partys point of view. So if the contracting party lived beyond the same period the company would come under an obligation limited only by the duration of the contracting partys life, to keep up the annual payments. Such an obligation is, of course, an ordinary incident of an annuity contract, but it seems wholly alien from a mere arrangement for accepting money on loan. The truth is that the transaction in the present case contains none of the characteristics of a contract of loan in which capital is handed over to be returned as capital. The $ 65,243 so far as the contracting party is concerned has, to use the language of Baron Watson in Foley v. Fletcher (28 L.J. Ex., at p. 109; 3 H. & N., at pp. 784-5), gone and ceased to exist, the principal having been converted into an annuity. The only continuing relation between the annuity and the vanished capital sum is that the amount of the vanished capital sum is arbitrarily taken to measure the minimum period for which the annuity is to run.

It was strongly urged that the fact that the repayments made by the company to the contractor in the case of Perrin v. Dickson (1930) 14 Tax Cas. 608 were held not to be chargeable to income-tax made it necessary for this Court to hold the like in the present case. The decision in Perrin v. Dickson (1930) 14 Tax Cas. 608 was

based on the fact that each member of the Court was satisfied that in that case the sums paid by Bishop Perrin were mere investments of capital received and in due course repaid by the company; that the transaction was merely one of a deposit of a fund with the company on the terms that the deposit should be repaid in one event without interest, but in the event of the whole scheme working out as anticipated, with compound interest calculated at 3 per cent. If that is the true view of the contract in question in Perrin v. Dickson (1930) 14 Tax Cas. 608, no doubt the repayments were not taxable but only the compounded interest. But it seems to me impossible to take a like view of the contract in the present case for the reasons I have given. Whether the view taken by the Court in Perrins Case (1930) 14 Tax Cas. 608 of the nature of the contract was consistent with the circumstance that if Bishop Perrin failed to keep up the periodical advances or premiums which he was bound by the contract to make he had no contractual right to recover them is a question which might, if the case had to be considered in a Court which had power to overrule that case, be a matter for serious consideration; as also whether the difficulty occasioned by the absence of such a contractual right could be properly treated as surmounted by evidence that it was the practice of the company in such circumstances to repay the advances or premiums. In whatever way these questions might be resolved by a Court which had power to overrule the decision in Perrin v. Dickson (1930) 14 Tax Cas. 608, there remains the crucial distinction between that case and the present that in that case the companys liability could never exceed the amount of the premiums with the compound interest at 3 percent., while in the present case the contract involved the company in a possible liability which, if Mr. Sothern lived for an unexpected number of years, might exceed the original payment and a reasonable rate of interest thereon by a very large figure. The existence of such a liability in the payee of the original capital sum appears to me to make the transaction differ crucially from a mere transaction of deposit or investment of a capital sum to be returned in due course as a capita sum. The transaction must in my view be treated as a parting with a capital sum as consideration for the grant of a number of periodical income payments, in other words for the grant of a number of periodical income payments, in other words for the grant of an annuity. I can thus find nothing in Perrins Case (1930) 14 Tax Cas. 608 which would induce, still less compel, me to hold that the

view which I have formed as stated above of the nature and effect of the contract in question in the present case is otherwise than correct.

For these reasons I am of opinion that the decision of the Special Commissioners was correct, and that the order of Lawrence, J., reversing their decision should not be upheld. Accordingly, in my view, the appeal of the Crown should be allowed.

GODDARD, L.J. -The difficulty that I have felt in this case is to determine whether it is distinguishable in principle from Perrin v. Dickson (1930) 14 Tax Cas. 608, a decision which is binding on this court. The fine distinction between an annuity properly so called for tax purposes and an annual payment which is in truth a capital payment, whether in discharge of a pre-existing debt or not, has repeatedly been emphasised, and no sure or simple test has or can be laid down for the solution of this problem. The only principle that 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 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, though in the latter case if the annual sum represents a payment, or a return of capital, coupled with interest, the sum may be dissected and tax charged on so much as represents interest. Now in the case of a whole life annuity the sum paid is not in truth a return of capital plus interest. The annual payment is calculated on the grantees expectation of life. He is to receive during his life an annual sum considerably in excess of the normal interest that he would obtain on an investment, while the grantor takes the risk of the life being prolonged beyond a period which will yield a profit to him on the transaction. The grantee retains no interest in the capital once it has been paid; it becomes the property of the grantor. The present case as between the company and the late Mr. Sothern is, in my opinion, one of an ordinary life annuity with an additional benefit attached, the company agreeing that in no event will they pay less than the amount of the capital they received from the annuitant. I find difficult to see why a payment to be made after his death to his nominee, or to his executors if the nominee should also have died, or if they had been nominated as beneficiaries, should change in character or quality, becoming capital and not income merely because the measure of the payment or payments is limited to an

amount which, added to what has already been paid to the granter, will be equivalent to the amount originally paid by him to secure the income. In Perrin v. Dickson (1930) 14 Tax Cas. 608 it was found in the case that the sum to be paid to the parent for the education of his child was, if the child survived for the whole period, the amount of the premiums plus 3 per cent. compound interest. The contract provided that if the child died the parent was to be paid the total amount of the premiums paid without interest, less any sum that might already have been received. The Court held, as I understand the decision, that the true nature of the transaction was no more than the accumulation, or saving, by the parent of a sum at compound interest to be applied when the time came for the education of the child, or returned to him without interest in the event of the earlier death of the child. In that view of the facts the transaction was in no sense an annuity and is quite different in quality from that which we are now considering. The opinion that I have formed makes it unnecessary to consider what effect, if any, the decision in Perrins Case (1930) 14 Tax Cas. 608 may have on terminable annuities. Obviously the transaction was closely akin to the grant of such an annuity, and the Court held that only so much of the payments as represented interest was taxable. It may yet have to be decided whether that principle must be applied to all cases of deterred terminable annuities, but as, in my opinion, this is not truly a case of a terminable, but of a whole life, annuity with an added benefit, I need express no opinion upon the question.

I think that the decision of the Special Commissioners was right and should be restored.

Appeal allowed.

Leave given to appeal to the House of Lords.