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COURT OF APPEAL—  
24, 25 AND 26 APRIL AND 12 MAY 1978

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HOUSE OF LORDS—10 AND 11 JULY AND  
25 OCTOBER 1979

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**Rank Xerox Ltd. v. Lane (H.M. Inspector of Taxes)<sup>(1)</sup>**

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C *Capital gains tax—Disposal of a right to what was termed a “royalty”—Whether a disposal of a right to an “annual payment due under a covenant not secured on any property”—Finance Act 1965 (c 25), Sch 7, para 12(c).*

D In 1957 the Xerox Corporation (“Xerox”) granted a licence to the Appellant Company (in which it was a shareholder) to enable it to exploit the xerographic process throughout the world, except in the U.S.A. and Canada. By an agreement made in 1964 (and subsequently amended) between the Appellant Company and Xerox, the former agreed to surrender to the latter its rights in Central and South America and the West Indies in consideration of, *inter alia*, the payment by Xerox to the Appellant Company of a royalty of 5 per cent. on certain net sales within the areas from which the Appellant Company was to be excluded. In 1969 the Appellant Company disposed of its right to the royalty by distributing the same *in specie* to its shareholders, each of whom (for a consideration) surrendered its portion of the dividend to Xerox. The Inspector of Taxes raised a corporation tax assessment on the Appellant Company to include the chargeable gain arising on that disposal. The Company, appealing to the Special Commissioners, contended (i) that the right had been received for the surrender of a capital asset; (ii) that the annual payments made by Xerox in satisfaction of that right were annual payments due under the covenant made by Xerox; and (iii) that para 12(c) of Sch 7 to the Finance Act 1965 applied to such payments with the result that no chargeable gain accrued. The Commissioners, whilst accepting that the payments made by Xerox were annual payments, decided, contrary to the Appellant Company’s remaining contentions, that the provisions of para 12(c) of Sch 7 were only applicable in relation to payments, the right to which would only be enforceable if the same were granted by a covenant (which was not so in this case), and that the expression “right to . . . annual payments which are due under a covenant made by any person and which are not secured on any property” referred to a right to annual payments due under a personal voluntary disposition of income, made by a deed of covenant.

H In the High Court the Crown accepted that the relevant payments did not form part of the Appellant Company’s trading receipts.

The Chancery Division, dismissing the appeal, held that, although the relevant payments were “due under a covenant” (made by a person and not secured on any property) within the meaning of para 12(c) of Sch 7 because the

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<sup>(1)</sup> Reported (Ch D) [1977] 3 WLR 410; [1977] 3 All ER 593; [1977] STC 285; [1978] Ch 1; 121 SJ 273; (CA) [1978] 3 WLR 643; [1978] 2 All ER 1124; [1978] STC 449; [1979] Ch 113; 122 SJ 813; (HL) [1979] 3 WLR 594; [1979] 3 All ER 657; [1979] STC 740; [1980] AC 562. [1980] AC 629

obligation to make such payments had been created by an undertaking embodied in a document executed under seal, the payments could not be construed as “annual payments” within the meaning of that sub-paragraph, having regard to the construction of those words in ss 52(3)(a) and 53(5)(b) of the 1965 Act, where “royalties” were distinguished from “annual payments” by s 169(3) of the Income Tax Act 1952. Accordingly the Company failed to gain exemption under para 12(c). The Company appealed. A  
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The Court of Appeal, unanimously allowing the appeal held (i) that the payments were annual payments within the meaning of para 12(c), Sch 7 (it being common ground that the basic characteristics, which have been held necessary for the identification of an “annual payment” in the Schedule D context, must also be taken to characterise an “annual payment” in the context of para 12(c), since (a) it would be a misuse of language to describe the payments as being made “in respect of the user of a patent” but if such payments could properly be so described as having been made “in respect of the user of a patent” that would not of itself prevent them from being “annual payments”, (b) if the position of the payee of royalty payments is such that his absolute entitlement to receive the same is wholly independent of any outgoings or expenses to which he may be liable, such payments can be pure income profit and thus “annual payments” and (c) while “annual payments” to be within the meaning of para 12(c) must exhibit the same general characteristics as in the Schedule D context, it does not follow that a payment having those characteristics cannot qualify as an “annual payment” under para 12(c) solely because it would fall to be charged under Schedule D under a different Case from Case III for reasons unconnected with and not affecting its character as an “annual payment”; and (ii) that the payments were “due under a covenant” within the meaning of para 12(c) since, in the context of the paragraph, “covenant” clearly bears its ordinary and primary meaning of a promise in a document executed by the promisor under seal. The Crown appealed. C  
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The House of Lords, unanimously allowing the appeal, held that the phrase “due under a covenant made by any person” referred only to unilateral promises of a voluntary character and did not extend to the contractual and bilateral agreement in the present case. The House expressed no view on the question whether the payments in question were “annual payments”. The House derived no assistance from the law of Scotland; “covenant” being regarded as a technical term of English law which, in a case arising in England, fell to be interpreted by the rules of English law: *Special Commissioners of Income Tax v. Pemsel* 3 TC 53; [1891] AC 531 applied. F  
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#### CASE

Stated under the Taxes Management Act 1970, s 56, by the Commissioners for the Special Purposes of the Income Tax Acts for the opinion of the High Court of Justice. H

1. At a meeting of the Commissioners for the Special Purposes of the Income Tax Acts held on 7 and 8 November 1973 and 16 July 1974 Rank Xerox Ltd. (hereinafter called “RXL”) appealed against the assessment to corporation tax for the accounting period of 12 months to 30 June 1970 in the sum of £49,100,000.

- A 2. Shortly stated the question for our determination was whether, as the Revenue contended, the profits for corporation tax purposes should include the chargeable gain (if any) which arose from the disposal of royalty rights or whether, as RXL contended, no chargeable gain accrued on the disposal because they were rights to annual payments due under a covenant not secured on any property within the meaning of para 12(c) of Sch 7 to the Finance Act 1965.
- B 3. Mr. Harry Edward Rose Shand the financial director of RXL, gave evidence before us.
4. The following documents were proved or admitted before us:
- (1) Extract from report of the chairman of The Rank Organisation Ltd. for the year ended 27 June 1964 (exhibit "C").
- (2) Directors' report and accounts for the period 29 June 1969 to 31 October 1970.
- C (3) Heads of agreement dated 30 November 1956 ("the 1956 agreement") between The Haloid Co. (now Xerox Corporation) ("Xerox"), The Rank Organisation Ltd. ("Rank") and Rank Precision Industries Ltd. (which company has changed its name to Rank Precision Industries (Holdings) Ltd. and is referred to herein as "RPH") (exhibit "A").
- D (4) Licence agreement dated 1 May 1957 between The Haloid Co. (now Xerox Corporation) and RXL ("the licence agreement").
- (5) Supplement to heads of agreement dated 19 February 1958 between Xerox, Rank and RPH ("the 1958 agreement").
- (6) (A) Agreement dated 20 February 1964 between Xerox and RXL ("the 1964 agreement") (exhibit "B"). (B) Agreement dated 20 February 1964 between Xerox, Rank and RPH amending the 1956 agreement. (C) Purchase agreement dated 20 February 1964 between Xerox and RXL.
- E (7) Agreement dated 1 January 1967 between Xerox and RXL ("the 1967 agreement") (exhibit "D").
- (8) Ordinary resolution passed at an extraordinary general meeting of the members of RXL on 11 December 1969.
- F (9) Agreement dated 11 December 1969 between Rank, RPH, Gaumont British Ltd. ("Gaumont"), RXL and Xerox ("the termination agreement").
- (10) Agreement dated 11 December 1969 between Rank, RPH, Gaumont and Xerox ("the royalty agreement").
- (11) Letter dated 9 October 1973 from RXL to Peat Marwick Mitchell & Co.
- G (12) Profit and loss accounts of RXL for period 1964 through 1970.
- (13) Tax computations of RXL for the period 1964 through 1970.
- (14) Bond issue prospectus of Rank: November 1971.

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

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

(A) Share Capital.

(1) The issued share capital of RXL is divided into five classes and is currently held as follows:

	"A" Shares	"B" Shares	"C" Shares	"D" Shares	"E" Shares	
Xerox Corporation ("Xerox")			6,356,147			B
Lyell Rank	7,401,254		1,125,241			
RPH		2,960,502		1,309,242		
Gaumont Trustees of the RXL Share Purchase Scheme		3,700,627		1,870,347		C
		740,125		561,105	32,950	
Total	7,401,254	7,401,254	7,481,388	3,740,694	32,950.	D

(2) The issued share capital of RXL on 11 December 1969 (the date of declaration of the specie dividend of the Latin American royalty right) was

	"A" Shares	"B" Shares	"C" Shares	"D" Shares	
Xerox Lyell			6,506,147		E
Rank	7,401,254		975,241		
RPH		2,960,502		1,309,242	
Gaumont		3,700,627		1,870,347	
Total		740,125		561,105	F
Total	7,401,254	7,401,254	7,481,388	3,740,694.	

(3) Lyell is and on 11 December 1969 was a wholly-owned subsidiary of Xerox.

(4) On 11 December 1969 Rank beneficially owned the whole of the issued share capital of Gaumont and 92 per cent. of the issued share capital of RPH.

(B) RXL and Xerox.

(1) RXL was incorporated in England as a limited liability company under the Companies Act 1948 on 9 December 1956. The principal object of RXL as set out in clause 3(A) of its memorandum is as follows:

"(A) To carry on all or any of the trades or businesses of designers, manufacturers, merchants, factors, importers, exporters, and wholesale and retail dealers of and in optical, scientific, technical, astronomical, surgical, computer, business, photographic, xerographic and cinematographic instruments, apparatus, appliances, materials and requisites of all kinds, duplicating, reproducing copying, xerographic and office equipment of all kinds, engines, plant, machinery, machine parts and accessories and machine H

A tools of all kinds, lenses, prisms, binoculars, telescopes, optical glass, photographic cameras, plates, films, papers, mounts and frames, cinematograph projectors, and films sound recording and reproducing apparatus, gramophones, electrical apparatus, and apparatus for use in all branches of telephony, telegraphy, wireless, facsimile, radio, television and public address systems."

B (2) Xerox is a company incorporated under the laws of the State of New York and is listed on the New York and London Stock Exchanges. The principal activities of Xerox include the development, manufacture and marketing of xerographic copiers, duplicators and related supplies. Xerox also develops, manufactures and markets computer products, educational materials and information services.

C (C) History.

(1) Pursuant to the 1956 agreement, Xerox (then called "the Haloid Co."), Rank and RPH (then a subsidiary of Rank) agreed: (a) jointly to exploit throughout the world (excluding the United States of America and its associated territories and possessions set out in para 3 below and Canada) the process known as "Xerography"; (b) to form a company RXL in England

D through which the business would be carried on; (c) to participate in the profits of RXL on the basis set out in the 1956 agreement. In addition: (i) Xerox agreed to provide RXL with "know-how" (subject to certain limitations); (ii) RXL agreed to grant exclusive licences to Xerox of inventions relating to the process developed by RXL; (iii) Xerox had a right to terminate the agreement after five years if the development of xerography through RXL was not satisfactory. A copy of the 1956 agreement is annexed hereto marked "A" and forms part of this Case<sup>(1)</sup>.

(2) On 1 May 1957 the licence agreement was entered into between Xerox and RXL. Pursuant to this agreement Xerox granted to RXL an exclusive licence to use certain patented inventions and an exclusive sub-licence in respect of certain specified licence rights for the exploitation of the reproduction process known as "xerography". (The xerographic process is defined in the agreement to mean "the art of forming and utilising an electrostatic charge pattern on an insulating or photoconductive insulating surface".)

F (3) The licence was granted to RXL in respect of the whole world excluding the United States of America (with its territories and possessions viz: Alaska, Hawaii, Puerto Rico, Virgin Islands, Panama Canal Zone, Guam and American Samoa) and Canada.

G (4) The licence agreement contained certain covenants to be observed and performed by RXL. These covenants included, *inter alia*, a covenant against assignment, a covenant not to dispute the validity of the letters patent and licence rights and a covenant to communicate to Xerox any improvement or invention or information data and "know-how" relating to xerography made or acquired by RXL.

H (5) In return, Xerox covenanted with RXL that it would enjoy and use the rights so granted "without any interruption or disturbance" by Xerox or any persons lawfully claiming under it.

I (6) In addition, Xerox agreed with RXL *inter alia*, (i) to notify RXL of improvements or invention data and "know-how" relating to xerography; (ii) to disclose to RXL all pertinent knowledge that Xerox might acquire in the future in respect of xerography; and (iii) not to grant any sub-licence or any

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(1) Not included in the present print.

agreement (other than certain specified agreements) affecting or relating to xerography anywhere in the territory in which RXL has been granted exclusive licences. A

(7) Under the 1958 agreement Xerox assigned to RXL certain rights which it had relating to a process known as "electrofax phases of xerography".

(8) Pursuant to the 1964 agreement between Xerox and RXL, RXL agreed to surrender to Xerox its right to manufacture and sell in Central and South America in exchange for the payment by Xerox to RXL of a royalty of 5 per cent. on "net sales" by Xerox in those areas. (i) Clause 1 of the 1964 agreement (as amended by the 1967 agreement) reads as follows: B

"Rank Xerox hereby sells, assigns and transfers to Xerox its entire right, title and interest in all property, rights and assets in and pertaining to the Western Hemisphere of whatsoever nature and description, including, without limitation, its goodwill, technical information, know-how, trade secrets, customer lists, patents, trademarks, patent applications, trademark applications, rights to apply for patents, and rights to apply for trademarks. As used herein, 'Western Hemisphere' shall mean that part of the world outside the Territory (as defined in the LICENCE AGREEMENT as hereinafter amended)." C D

(9) Under the 1964 agreement (as amended by the 1967 agreement) "the Territory" definition applicable to the licence agreement was reduced from:

"the world excluding the United States of America (with its territories and possessions viz: Alaska, Hawaii, Puerto Rico, Virgin Islands, Panama Canal Zone, Guam and American Samoa) and Canada". (see page 1, exhibit (A)) to "(i) . . . that part of the world west from 165° longitude west to 30° longitude west, excepting only (i) those parts of States of the United States of America and Greenland located therein and (ii) those areas located therein which are under or associated with the sovereignty of the United States of America meaning American Samoa and Guam, Midway, Wake, Howland, Baker, Johnston, Marshall, Mariana, and Caroline Islands." E F

Thus, by the variation of the definition RXL was to be precluded from continuing the exploitation of the xerographic process in Central and South America.

(10) As consideration for the surrender by RXL to Xerox of the rights in the "Western Hemisphere", Xerox agreed (under clause 4 of the 1964 agreement referred to in para (8) above) to pay to RXL "a royalty of 5% of Net Sales in the Western Hemisphere with the exception of the United States of America, its territories and possessions, and Canada". The provisions of clause 4 went on to define the meaning of "net sales". A copy of the 1964 agreement is annexed hereto marked "B" and forms part of this Case<sup>(1)</sup>. A copy of an extract from the chairman of Rank Organisation Ltd. Mr. J. Davis' report included in the account for the year ended 27 June 1964 is annexed hereto marked "C" and forms part of this Case<sup>(1)</sup>. G H

(11) Under the 1967 agreement RXL agreed to surrender to Xerox its rights to manufacture and sell in the British West Indies in exchange for the payment by Xerox of a similar royalty of five per cent. on "net sales" in that area. The amendment was effected by a further re-definition of "the Territory". A copy of the 1967 agreement between Xerox and RXL is annexed hereto marked "D" and forms part of this Case<sup>(1)</sup>. I

(1) Not included in the present print.

A (12) During 1969 a series of negotiations took place between Rank and Xerox concerning the future of RXL. The final terms of the agreement reached between Rank and Xerox are set out in the shareholders' agreement of 4 December 1969 and the schedules thereto. Broadly speaking, the areas which were negotiated were those concerning (a) the change of voting control of RXL from Rank to Xerox and (b) the surrender by RXL of its right to receive the B royalty payments under the 1964 and 1967 agreements. As overall compensation for the "deal" Xerox agreed to pay to Rank the sum of US \$20,000,000 to be satisfied by the issue of shares of common stock of Xerox to Rank.

C (13) The precise mechanics involved in connection with the surrender by RXL to Xerox of the right ("the Latin American royalty rights") to receive the royalty payments under the 1964 and 1967 agreements are set out in the following paragraphs.

D (14) Pursuant to the termination agreement of 11 December 1969 the 1956 agreement was terminated. By an agreement on 11 December 1969 between Rank, RPH, Gaumont and Xerox ("the royalty agreement"), Rank, RPH and Gaumont agreed that if RXL were to declare a dividend *in specie* of the Latin American royalty rights, then each of them would surrender to Xerox the entire E rights to which they became entitled and Xerox would purchase those rights for the sum of US \$7,500,000. It was agreed that such consideration would be satisfied by the issue of shares of common stock of Xerox (par value US \$1) at the closing market price of the shares on the New York Stock Exchange on the business day preceding the holding of the extraordinary general meeting pursuant to which the Latin American royalty right was to be declared as a dividend. The object of this agreement was to secure that following the declaration of the *specie* distribution, Rank, RPH and Gaumont could secure the sale to Xerox of the proportion of the rights to which they became entitled.

F (15) By a resolution of the board of directors of RXL passed on 11 December 1969 it was resolved that the value of the Latin American royalty rights be written up in the books of RXL to £8,400,000. In addition, the board further resolved that a resolution be put to the company in general meeting for a dividend of £8,400,000 to be declared and to be satisfied by distributing amongst the members in due proportions the whole of the Latin American royalty rights.

G (16) At an extraordinary general meeting of RXL held on 11 December 1969 an ordinary resolution was passed to the effect that RXL pay a dividend of £8,400,000 to be satisfied by the distribution of the Latin American royalty rights among the shareholders of the company in the proportions stated in the resolution.

H (17) Following the passing of the ordinary resolution referred to above each of the members of the company, namely, Xerox, Lyell, RPH, Rank and Gaumont became entitled to a proportion of the Latin American royalty rights. By cancellation agreement I of 11 December 1969 Rank, RPH and Gaumont surrendered to Xerox their share of the Latin American royalty rights against the issue by Xerox to those persons of 70,093 shares of common stock of Xerox. On the same date, by a cancellation agreement II, Lyell surrendered to Xerox its proportion for a consideration of US \$3,528,000.

I (18) As between RXL and Xerox, a letter of confirmation was written by RXL on 12 December 1969 that the royalty right had been terminated.

6. It was contended on behalf of RXL that :

(a) the Latin American royalty rights were rights received for the surrender of a capital asset;

(b) the annual payments made by Xerox in satisfaction of those rights were annual payments;

(c) these payments were due under a covenant made by Xerox;

(d) the conclusion was that para 12(c) of Sch 7 to the Finance Act 1965 applied to these payments and that the appeal should succeed.

7. It was contended on behalf of the Inspector of Taxes that:

(a) the payments made by Xerox to RXL under the 1964 and 1967 agreements were not pure profit income but were part of the trading receipts of RXL and this could not be "annual payments" within the meaning of para 12(c), Sch 7, Finance Act 1965;

(b) the said payments were "royalties" and, on the true construction of the said para 12(c) "royalties" are not "annual payments" within the meaning thereof;

(c) if the said payments were "annual payments" they were not "annual payments . . . due under a covenant" within the meaning of the said paragraph, since, on the true construction thereof the only payments embraced by the same are payments of bounty made under a deed of covenant;

(d) the distribution of the royalty rights to the shareholders of RXL in December 1969 represented the disposal of an asset for the purposes of Part III, Finance Act 1965, and that if a gain was found to arise from that disposal it should be charged to corporation tax by the assessment before the Commissioners in accordance with s 46, Finance Act 1965;

(e) the appeal should be dismissed in principle and the figures left for agreement between the parties.

8. The following cases were referred to at the hearing: *Delage v. Nugget Polish Co. (Ltd.)* 21 TLR 454; *British Dyestuffs Corporation (Blackley), Ltd. v. Commissioners of Inland Revenue* 12 TC 586; *Commissioners of Inland Revenue v. Tootal Broadhurst Lee Co., Ltd.* 29 TC 352; *British Commonwealth International Newsfilm Agency, Ltd. v. Mahony* 40 TC 550; [1963] 1 WLR 69; *G. W. Plowman & Son Ltd. v. Ash* [1964] 1 WLR 568; *Murray v. Imperial Chemical Industries Ltd.* 44 TC 175; [1967] Ch 1038; *Campbell & Another v. Commissioners of Inland Revenue* 45 TC 427; [1970] AC 77.

9. We, the Commissioners who heard the appeal, took time to consider our decision and gave it in writing on 5 August 1974 as follows:

(1) The question for decision is whether the disposal, in 1969, of what has been described as the royalty rights, was a "disposal of a right to . . . annual payments which are due under a covenant made by any person and which are not secured on any property" within para 12(c) of Sch 7 to the Finance Act 1965.

(2) The rights disposed of were the company's rights to certain payments from Xerox Corporation under two agreements dated 20 February 1964 and 1 January 1967 respectively, each made between Xerox Corporation and RXL. It is common ground that each agreement was executed by Xerox Corporation as a deed, but was not executed as a deed by RXL. The two agreements were substantially of similar nature; by clause 1 RXL sold and assigned to Xerox Corporation its rights to exploit certain processes in certain territories; clause

A 2 amends the agreement from which such rights stemmed in order to give effect to clause 1; clause 3 deals with certain ancillary matters; clause 4 provides: "In consideration of the premises, Xerox" [i.e. Xerox Corporation] "shall pay or cause to be paid to Rank Xerox" [i.e. RXL] "a royalty of 5% of net sales in the Western Hemisphere" with certain territorial exceptions. There follows a detailed definition of net sales, and provisions concerning

B method of payment. Each agreement stated that it should be construed in accordance with English law. It is the right to such royalty payments which we have to consider in relation to the said para 12(c). What, precisely has para 12(c) in contemplation when it refers to annual payments which are due under a covenant made by any person? We first look to see whether any help is available from the context. Paragraphs 11, 11(a), 12 and 13 appear under a sub-

C title "Debts and interests in settled property". Paragraphs 11 and 11(a) are concerned with certain debts, para 13 with interests in settled property, and para 12 with (a) certain superannuation rights, (b) certain annuities granted by life companies and (c) certain annual payments, i.e. annual payments which are due under a covenant etc. We are not able to get any clear guidance from the context.

D (3) Both "annual payments" and "covenants" have important places in the law relating to income tax and associated taxes. Annual payments are charged to income tax, being grouped with interest and annuities. There is a great deal of authority on the meaning of the term in the income tax context, and if we had a question whether the royalties were annual payments chargeable to income tax we would hold that they were. Covenants (and here our remarks

E are restricted to such covenants as may give rise to annual payments) do not figure so prominently in the income tax legislation as they do in taxation practice. Where the legislation does refer to a covenant it points, we think, to a disposition of income which might be unenforceable unless made under seal. Thus in Part XVI of the Income and Corporation Taxes Act 1970, which deals with settlements, the definitions of "disposition" (s 434(2)) and of "settlement"

F (s 444(2)) include the word "covenant", and the principal target appears to be a voluntary disposition. Section 248, which deals with charges on income for corporation tax purposes, refers to a "covenanted donation to charity", which it defines as a payment under a disposition or covenant made by a company. The covenant must be "made by any person". This would appear to exclude annual payments under a covenant implied in any particular document or

G situation. The annual payments must not be *secured on any property*; the inclusion of these words would seem to be dictated by the general structure of the capital gains tax; this does not assist us of itself, but to our minds "made by any person and which are not secured on any property" does seem to indicate a self-contained covenant of a personal nature.

H (4) In our opinion para 12(c) refers to a right to annual payments which would be unenforceable if not granted by covenant; were it not so, we could think of no reason why the words "due under a covenant" were inserted. The royalty rights in the present case would, in our opinion, have been enforceable if Xerox Corporation had not executed the agreements as deeds, and for this reason we hold that in any event the appeal must fail. We would, however, go further, and say that the whole expression "right to . . . annual payments which

I are due under a covenant made by any person and which are not secured on any property" refers to a right to annual payments due under a personal voluntary disposition of income, made by deed of covenant. We reach this further conclusion in the light of what we have said in para 3 above.

(5) We are fortified in our conclusion by the fact that it does avoid the result (which we cannot think was intended by Parliament) that the charge to

capital gains tax could stand or fall on whether or not Xerox Corporation executed the agreements as deeds—which might, for all we know, have been quite fortuitous. A

(6) We dismiss the appeal and leave the figures to be agreed.

10. The Appellant, immediately after the determination of the appeal, declared to us its dissatisfaction therewith as being erroneous in point of law and required us to state a Case for the opinion of the High Court pursuant to s 56, Taxes Management Act 1970, which Case, we have stated and do sign accordingly. B

11. Having regard to the remarks of Rowlatt J. in *MacLaine & Co. v. Eccott*<sup>(1)</sup> 10 TC 481, at page 550, we have considered it desirable to state this Case on a question of principle only at the request of the Appellant and with the concurrence of the Inspector of Taxes in order to avoid the delay occasioned by waiting for an agreement of the figures of assessment in accordance with our decision set out in para 9 hereof. When the High Court has decided the question of principle in dispute, the Case will require to be remitted to the Special Commissioners in order that the assessment may be adjusted in accordance with the judgment of the Court. C

The question of law for the opinion of the Court is whether our decision set out in para 9 (above) is correct in law. D

H. G. Watson                    { Commissioners for the Special Purposes  
R. A. Furtado                 { of the Income Tax Acts

Turnstile House  
94–99 High Holborn  
London WC1V 6LQ  
3 June 1975

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SUPPLEMENTAL CASE

Stated under the direction of the Chancery Division.

1. On 8 July 1976 by Order of the Chancery Division of the High Court of Justice the Case stated by us under s 56, Taxes Management Act 1970, was remitted to us with a direction that we: (1) make a determination in relation to the contentions contained in paras 6(b) and 7(a) of the Case; (2) state the facts on which we base that determination. F

2. One of us, the Commissioners who stated the Case, having since retired from the public service, and the Appellant not agreeing to this Supplemental Case being stated by one Special Commissioner only, the retired Commissioner was obliged to obtain a fresh Warrant enabling him to act in this matter, which has occasioned the delay in stating this Supplemental Case. G

3. The contention in para 6(b).

At the hearing of the appeal the arguments and contentions of both parties were put upon the basis that the words “annual payments” in para 12(c) of Sch 7 to the Finance Act 1965 bore the same meaning as the words bear in H

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(1) [1926] AC 424.

A relation to income tax, and para 4 of our decision set out in the Case was intended to be read as accepting that proposition. Our intent in para 3 of our said decision was to express a determination that the payments in question were "annual payments", giving the words the aforesaid meaning. Our determination was, and is, that the payments in question were annual payments within the said para 12(c).

B 4. The contention in para 7(a).

From the authorities to which we were referred at the hearing concerning "annual payments" in relation to income tax it appeared that payments which form part of a trader's trading receipts and are not what has been described in certain authorities as "pure profit income" cannot be "annual payments". We did not understand either party to dispute this. Our determination was and is (as recorded in 3 above) that the payments in question were "annual payments"; in reaching this determination we concluded that they were not trading receipts of Rank Xerox Ltd. but could properly be called "pure profit income".

5. The facts upon which the determination is based.

We annex hereto the documents listed in para 4(11), (12) and (13) of the Case, as exhibits E, F and G respectively<sup>(1)</sup>. These show how the payments in question were dealt with in the annual accounts and tax computations of Rank Xerox Ltd. Mr. Shand stated in his evidence, and we accepted it, that Rank Xerox Ltd. incurred no expense in connection with the receipt of such payments. It was and is our opinion that the manner in which the payments were recorded in the accounts of Rank Xerox Ltd. and the manner in which the tax computations were made is only of very slight assistance in determining the true nature and quality of the payments, which in our view depends almost entirely upon the facts set out in para 5 of the Case.

H. G. Watson                    { Commissioners for the Special Purposes  
R. A. Furtado                    { of the Income Tax Acts

Turnstile House

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5 January 1977

The case was heard in the Chancery Division by Slade J. on 28 February and 1 March 1977 when judgment was reserved. On 9 March 1977 judgment was given in favour of the Crown, with costs.

G *Michael Nolan Q.C.* and *A. R. Thornhill* for the Company.

*Donald Potter Q.C.* and *Brian Davenport* for the Crown.

The following cases were cited in argument in addition to those referred to in the judgment:—*British Commonwealth International Newsfilm Agency Ltd. v. Mahany* 40 TC 550; [1963] 1 WLR 69; *Varty v. Lynes* 51 TC 419; [1976] 1 WLR 1091; *Perry v. Astor* 19 TC 255; [1935] AC 398; *Westminster Bank Executor and Trustee Co. (Channel Islands) Ltd. v. National Bank of Greece S.A.* 46 TC 472; [1971] AC 945.

(1) Not included in the present print.

**Slade J.**—This is an appeal by way of Case Stated against a decision of the Commissioners for the Special Purposes of the Income Tax Acts upholding in principle an assessment to corporation tax which had been made against the Appellant, Rank Xerox Ltd., for the accounting period of twelve months to 30 June 1970. A

On 11 December 1969, at an extraordinary general meeting of the Appellant (which I shall call “RXL”), an ordinary resolution was passed to the effect that RXL should pay a dividend of £8,400,000 to be satisfied by the distribution of what are described in the Case Stated as “the Latin American royalty rights” among the shareholders of RXL in the proportions specified in the resolution. Briefly, the Latin American royalty rights were the right to receive from Xerox Corporation (which I shall call “Xerox”) under two contracts, executed by Xerox under seal respectively on 20 February 1964 and 1 January 1967 5 per cent. of the net sale proceeds from sales and rentals of xerographic equipment in Central and South America by Xerox or its subsidiaries. B C

The assessment in question was made because under s 238(1) of the Income and Corporation Taxes Act 1970 (“the Taxes Act 1970”) corporation tax falls to be charged on “profits” of RXL and, under s 238(4)(a), “profits” for this purpose include “chargeable gains”. Under s 265 of that Act, for all purposes relevant to the present case, “chargeable gains” fall to be computed in accordance with the principles applicable for capital gains tax. In the result, this appeal is primarily concerned with the capital gains tax legislation contained in the Finance Act 1965 and one paragraph thereof in particular. It is common ground that the Latin American royalty rights were “assets” within the definition of “assets” contained in s 22(1) of the Finance Act 1965; that the distribution of these rights to shareholders of RXL in December 1969 constituted the “disposal” of assets for the purpose of Part III of that Act; and that, under s 22(4) of that Act, such disposal would for the purposes of Part III be deemed to be for a consideration equal to the market value of such rights. The actual assessment to corporation tax made against RXL was in a sum of £49,100,000. Since, however, questions of valuation in accordance with s 22(4), if they arose, might give rise to considerable difficulty, the Commissioners have stated the Case on a question of principle only, in accordance with the observations of Rowlatt J. in *Maclaine & Co. v. Eccott*<sup>(1)</sup> 10 TC 481, at page 550. In the light of what I have said, it is further common ground that the only issue before the Court is whether or not, as RXL contends, para 12(c) of Sch 7 to the Finance Act 1965 operates to relieve RXL from liability to tax on the notional gain arising from the distribution of the Latin American royalty rights in 1969. If it does so operate, RXL escapes liability; if it does not, RXL is taxable. Paragraph 12 of Sch 7 to the Finance Act 1965 reads as follows: D E F G

“No chargeable gain shall accrue to any person on the disposal of a right to, or to any part of—(a) any allowance, annuity or capital sum payable out of any superannuation fund, or under any superannuation scheme, established solely or mainly for persons employed in a profession, trade, undertaking or employment, and their dependants, (b) an annuity granted otherwise than under a contract for a deferred annuity by a company as part of its business of granting annuities on human life, whether or not including instalments of capital, or an annuity granted or deemed to be granted under the Government Annuities Act 1929, or (c) annual payments which are due under a covenant made by any person and which are not secured on any property.” H I

(1) [1926] AC 424.

(Slade J.)

- A The question now before the Court in the end turns upon the construction of the 20 words of sub-para (c) and their applicability (if any) to the Latin American royalty rights.

I now turn to a more detailed examination of the facts of the case. RXL was incorporated in England on 9 December 1956 as a limited liability company, under the Companies Act 1948. Xerox is a company incorporated under the laws

- B of the State of New York. Both companies have objects which empower them, *inter alia*, to develop, manufacture and market xerographic copiers, duplicators and related supplies. On 30 November 1956 an agreement ("the 1956 agreement") was entered into between Xerox (then called "The Haloid Company"), of the first part, The Rank Organisation Ltd. ("Rank"), of the second part, and Rank Precision Industries Ltd. ("RPI"), of the third part. By the 1956 agreement
- C Xerox, Rank and RPI agreed: (a) jointly to exploit throughout the world excluding Canada, the United States of America and what were described as its territories and possessions—namely, Alaska, Hawaii, Puerto Rico, Virgin Islands, Panama Canal Zone, Guam and American Samoa—the reproduction process known as "xerography", the area of such exploitation being defined as "the territory"; (b) to incorporate in England a company through which the
- D business would be carried on; (c) to participate in the profits of the new company on the basis set out therein. In addition, by clause 4(b) of the 1956 agreement, Xerox agreed that it would transfer to the new company or procure the transfer to it of all Xerox patents, patent applications and licence rights then or thereafter owned, registered or applied for by Xerox in the territory in respect of or relating to xerography, particulars of all such patents, etc., up to the date thereof being
- E set out in the first schedule.

RXL was duly formed pursuant to the 1956 agreement. Pursuant to its provisions, by a licence agreement of 1 May 1957, made between RXL and Xerox ("the licence agreement"), Xerox granted to RXL an exclusive licence to use the inventions comprised in the letters patent and an exclusive sub-licence to use the inventions comprised in the licence rights respectively set out in the first

- F schedule to the 1956 agreement in order to exploit the process, xerography, throughout the same area as "the territory" as defined by the 1956 agreement, for the whole terms of such letters patent and licence rights, subject to certain rights of prior determination. The licence agreement contained a similar definition of "the territory". On 19 February 1958 the licence agreement was extended so as to cover rights with reference to so-called "electrofax phases of xerography".
- G On 20 February 1964 a further agreement ("the 1964 agreement") was entered into between Xerox and RXL. By clause 2, the licence agreement was amended in certain respects, in particular by amending the definition of "the territory" so as to reduce its area. By clause 1, RXL sold, assigned and transferred to Xerox all its rights in all property, rights and assets in the "western hemisphere" of whatever nature, excluding only its stock in Rank Xerox de Mexico S.A. but
- H including, without limitation, its know-how, patents, trade marks and so forth. For this purpose, "western hemisphere" was defined as meaning that part of the world outside "the territory" as defined in the licence agreement, as amended by clause 2 of the 1964 agreement. Clause 4 of the 1964 agreement provided as follows:

- I "In consideration of the premises, Xerox shall pay or cause to be paid to Rank Xerox (RXL) a royalty of 5% of Net Sales in the Western Hemisphere with the exception of the United States of America, its territories and possessions and Canada."

(Slade J.)

Clause 4 of the 1964 agreement then contained a definition of the expression "net sales", which broadly was defined as meaning the amounts billed to ultimate users by or on behalf of Xerox or of any company controlled by it or of appointed distributors thereof for sales and rentals of xerographic equipment less certain specified deductions. Finally, clause 4 provided as follows: A

"Such royalty payments shall be made or caused to be made by Xerox quarter-annually in the currency of the country in which the xerographic machines, equipment, apparatus, paper and supplies are delivered, except that where the existing laws of any country specifically authorise payment in pounds sterling, royalties with respect to such country may, at the option of Xerox, be paid in pounds sterling in London. Where the existing laws of any country restrict the transfer of funds from such country, royalty payments with respect to such country shall be credited to the account of Rank Xerox in such country." B C

Clause 6 of the 1964 agreement provided that it was made in England and should be construed in accordance with English law. The effect of the amendment of the definition of "the territory" made by the 1964 agreement was broadly that RXL surrendered to Xerox its rights to continue the exploitation of xerography in Central and Southern America in exchange for the payment by Xerox of what was described in the agreement as a "royalty of 5% of Net Sales" in that area (and was in my judgment properly described as a royalty). Under an agreement of 1 January 1967, made between Xerox and RXL ("the 1967 agreement"), which was substantially in the same form, *mutatis mutandis*, as the 1964 agreement and contained a further amendment of the definition of "the territory", RXL surrendered to Xerox its right to exploit xerography in the British West Indies, again in exchange for the payment by Xerox of a "royalty of 5% of Net Sales" in that area. Xerox (though not RXL) executed both the 1964 and 1967 agreements under seal. D E

On 4 December 1969 Rank and Xerox entered into a shareholders' agreement concerning the future of RXL. The broad effect of this agreement is summarised in the Case Stated, as are the steps which the parties took by way of implementation of it. The details of these transactions are not material for present purposes. It will suffice to say that (*inter alia*) on 11 December 1969 RXL passed the resolution which has already been mentioned, to the effect that it should pay a dividend of £8,400,000 to be satisfied by the distribution of its rights to royalty payments from Xerox under the 1964 agreement and the 1967 agreement, among the shareholders of RXL in the proportions stated in the resolution. The rights to receive these royalty payments are those referred to in the Case Stated as "the Latin American royalty rights". It was the distribution of these rights which gave rise to the assessment to corporation tax which is in issue in the present case. F G

The Commissioners who heard RXL's appeal gave their written decision on 5 August 1974, dismissing the appeal and leaving the figures to be agreed. Their reasoning has, I think, with one principal exception, been substantially reflected in the argument which has been put to me on behalf of the Crown, to which I will refer hereafter. As appears from para 7(a) of the Case Stated, it was (*inter alia*) contended on behalf of the Crown before the Commissioners that the payments made by Xerox to RXL under the 1964 and 1967 agreements were not "pure profit income", but were part of the "trading receipts" of RXL, and thus could not be "annual payments" within the meaning of para 12(c) of Sch 7 to the Finance Act 1965 (which I shall henceforth call "para 12(c)"). As appears H I

(Slade J.)

- A from para 6(b) of the Case Stated, it was (*inter alia*) contended on behalf of RXL before the Commissioners that these payments were "annual payments". On 8 July 1976, on the application of Counsel for the Crown and by consent, Goulding J. ordered that the Case which had been stated by the Commissioners and had been dated 3 June 1975 be remitted to them, with a direction that they should make a determination in relation to the contentions contained in paras 6(b) and
- B 7(a) of the Case and state the facts on which they based that determination. The Commissioners, on 5 January 1977, accordingly stated a Supplemental Case, in which they explained their intent in reaching their previous decision substantially as follows. They had regarded the words "annual payments" in para 12(c) as bearing "the same meaning as the words bear in relation to income tax"; they had regarded the relevant payments as not constituting part of the "trading receipts" of RXL but as constituting "what has been described in certain
- C authorities as 'pure profit income'"; they had accordingly regarded the relevant payments as being "annual payments", both within the meaning which that phrase bears in relation to income tax and within para 12(c); they had therefore intended to accept the contention referred to in para 6(b) of the original Case and to reject the contention referred to in para 7(a). In the circumstances, Mr.
- D Potter, on behalf of the Crown, told me that he did not wish to pursue the latter contention. Accordingly, the case has been argued on the footing that the relevant payments did not form part of the "trading receipts" of RXL.

- The language of para 12(c) itself makes it clear that, if the exemption thereby conferred is to be obtained, four conditions have to be fulfilled, namely, (1) the rights disposed of must be rights to "annual payments" within the meaning of para 12(c); (2) such payments must be "due under a covenant" within the said meaning; (3) such covenant must have been made by a "person", and (4) the payments must not be "secured on any property". There can be no doubt that the third and fourth conditions are complied with on the present facts. The questions arise as to the first and second. I think it will be convenient to deal with the second condition first. Accordingly, it is necessary to consider whether
- E the payments made by Xerox under the 1964 and 1967 agreements were "due under a covenant" within the meaning of para 12(c). At first sight it would appear clear that they were; and so Mr. Nolan, on behalf of RXL, has contended. A "covenant" is defined in Halsbury's Laws of England, 4th edn, vol 12 (1975), para 1539, as "an agreement under seal whereby the parties, or some or one of them, are or is bound to do or not to do a specified thing". Mr. Nolan pointed
- F out that in some contexts the word "covenant" may be construed as covering stipulations in an agreement under hand only; and he did not concede that the word might not be construed in this broader sense in the context of para 12(c). I do not think it can be so construed in this broader sense in this context. In my judgment, in para 12(c) the word "covenant" must bear its usual meaning as set out in Halsbury in the passage which I have quoted. Even on that footing,
- G however, there is *prima facie* no reason why the payments due from Xerox under the 1964 and 1967 agreements cannot properly be described as "payments due under a covenant", since those agreements were made by Xerox under seal and clause 4 thereof imposed the obligations to pay. Mr. Potter, on behalf of the Crown, however, submitted in effect that this was too crude and simple a way to approach the point. More subtly, he submitted that the words "due under a covenant" can mean either (a) that the obligation happens to be secured by a covenant, but would exist as a simple contract debt irrespective of the covenant, or (b) that it would not be due if there were no covenant. Construction (a), he submitted, would in the present case produce a capricious result which cannot have been intended by the Legislature and would enable a
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(Slade J.)

taxpayer, simply by procuring that a seal was added to the relevant document, to ensure that a liability was avoided which the Legislature plainly intended him to bear. Mr. Potter referred me to a passage from the majority judgment of the Privy Council in *Mangin v. Inland Revenue Commissioner* [1971] AC 739, at page 746, in which the rules of interpretation falling to be applied in the construction of Taxing Statutes were thus summarised:

“First, the words are to be given their ordinary meaning. They are not to be given some other meaning simply because their object is to frustrate legitimate tax avoidance devices. As Turner J. says in his (albeit dissenting) judgment in *Marx v. Inland Revenue Commissioner* [1970] N.Z.L.R. 182, 208, moral precepts are not applicable to the interpretation of revenue statutes. Secondly, ‘. . . one has to look merely at what is clearly said. There is no room for any intendment. There is no equity about a tax. There is no presumption as to tax. Nothing is to be read in, nothing is to be implied. One can only look fairly at the language used’: per Rowlatt J. in *Cape Brandy Sydicate v. Inland Revenue Commissioners*<sup>(1)</sup> [1921] 1 K.B. 64, 71, approved by Viscount Simon, L.C. in *Canadian Eagle Oil Co. Ltd. v. The King*<sup>(2)</sup> [1946] A.C. 119, 140. Thirdly, the object of the construction of a statute being to ascertain the will of the legislature it may be presumed that neither injustice nor absurdity was intended. If therefore a literal interpretation would produce such a result, and the language admits of an interpretation which would avoid it, then such an interpretation may be adopted. Fourthly, the history of an enactment and the reasons which led to its being passed may be used as an aid to its construction.”

Mr. Potter, in reliance on the third of these principles, submitted that it would be an unjust and absurd result if a taxpayer in the position of RXL in the present case could escape what otherwise would be a clear liability simply because the document under which the relevant payments were due had been executed under seal. He further submitted that the immediately preceding paras 12(a) and 12(b) may, broadly, be said not to deal with payments due under commercial transactions and that the reasonable construction to apply to para 12(c) is similarly to limit it to payments due under “non-commercial transactions” by confining its operation to payments due under voluntary covenants.

I find myself unable to accept these particular lines of argument put forward on behalf of the Crown. I do not accept that paras 12(a) and 12(b) relate only to payments due under “non-commercial transactions”. More importantly, these contentions involve the proposition that a payment can be said to be “due under a covenant” for the purpose of para 12(c) only if it is the existence of a seal, and nothing but the existence of a seal, on the relevant document which makes the payment legally enforceable. This seems to me an artificial construction of the relevant phrase which is not justifiable by reference to any supposed intention of the Legislature. If one embarks on the process of balancing the anomalous consequences that would result from either construction of the words “due under a covenant”, the anomalies are not found to be all on one side. If the Crown’s construction is correct, the disponent gains the exemption simply because the obligation to make the payments in question was gratuitously undertaken. Yet there is no general principle of capital gains tax which exempts a disponent from tax on a chargeable gain arising on a disposition simply because he originally acquired the subject-matter of the disposition through another’s gift. Why should he do so in the present case?

(1) 12 TC 358, at p 366.

(2) 27 TC 205, at p 248.

(Slade J.)

- A Furthermore, the words “not secured on any property”, which appear in para 12(c), themselves to some extent militate against the correctness of the Crown’s contention that para 12(c) is intended to apply only to payments due under a voluntary covenant. It must surely be rare for obligations under voluntary covenants to be secured on property. Anomalous results can therefore be said to result from the Crown’s construction of the paragraph as much as from the taxpayer’s construction. In my judgment, on the ordinary use of legal language, a payment is properly said to be “due under a covenant” in any case where the obligation to make it is created by an undertaking to make the payment which is embodied in a document executed under seal. The obligations to make the relevant payments in the present case were created by undertakings to make the payments which were embodied in the 1964 and 1967 agreements. These two agreements were executed by Xerox under seal. It follows, in my judgment, that the relevant payments are payments “due under a covenant” within the meaning of para 12(c). Thus the second of the four conditions which have to be fulfilled if exemption under para 12(c) is to be obtained is, in my judgment, complied with.

- D Accordingly, I now turn to consider whether or not RXL can surmount the last hurdle in its way, by showing that the payments in question are “annual payments” within the meaning of para 12(c). The phrase “annual payments” is nowhere defined in the Finance Act 1965. If payments are to fall within the definition, it is clear that they must possess (*inter alia*) the essential quality of recurrence implied by the description “annual”. This the relevant payments in the present case possess. In my judgment, however, it is equally clear that not all payments possessing the appropriate quality of recurrence will fall within the definition; if they did, paras 12(a) and 12(b) would have been largely superfluous. On any footing, therefore, it is necessary to attribute to the phrase “annual payments” a meaning narrower than payments which possess the quality of recurrence implied by the description “annual”. The difference between RXL and the Crown is as to where one should draw the line. Mr. Nolan, on behalf of RXL, submitted that the line is to be drawn by distinguishing those annual payments which are in the nature of “pure profit income” in the hands of the recipient and those which are not. All annual payments falling within the former category, he submitted, will constitute “annual payments” within the meaning of para 12(c), while those falling within the latter category will not. The Commissioners have found that the relevant payments in the present case constituted “pure profit income”, and there is no appeal from that part of their decision. It follows, in RXL’s submission, that the relevant payments are “annual payments” within the meaning of para 12(c). In amplification of this submission, Mr. Nolan submitted that the relevant payments would be taxable under Case III(a) of Schedule D as set out in s 123(1) of the Income Tax Act 1952 (now replaced by s 109 of the Taxes Act 1970), as constituting “(a) any interest of money, whether yearly or otherwise, or any annuity, or other annual payment . . .”. He sought to support this submission by reference to certain authorities, such as *Carson v. Cheyney’s Executor*<sup>(1)</sup> 38 TC 240 and *Wild v. Ionides* 9 TC 392, which, he suggested, show, at least by implication, that this wording of the Case III charge is wide enough to include payments by way of royalty, though he of course accepted that such payments may be chargeable under Case I if they are received “in respect of any trade carried on in the United Kingdom or elsewhere”, or under Case II if they are received “in respect of any profession or vocation”, or under Case V if they are foreign

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(1) [1959] AC 412.

(Slade J.)

royalties and represent "income arising from possessions out of the United Kingdom". He also accepted that payments made by way of royalty might be chargeable under Case VI if they did not represent "pure profit income" in the hands of the recipient: compare *Curtis Brown, Ltd. v. Jarvis* 14 TC 744. A

Mr. Potter, on behalf of the Crown, submitted that the decisions in *Carson v. Cheyney's Executor*<sup>(1)</sup> and *Wild v. Ionides*<sup>(2)</sup> do not constitute authority for the proposition that royalty payments are capable of being charged under Case III of Schedule D. He submitted that, unless they fell within any of the other Cases, they would fall within Case VI. On the particular facts of the present case he submitted that the relevant payments would fall within Case V, because (*inter alia*) they fall to be made by an overseas payer, *prima facie* in overseas currency, and, though the relevant documents are governed by English law, they all relate to overseas activities. B C

I think that the question whether the relevant payments fall within Case III, Case V or Case VI is a difficult one. It seems clear that payments cannot fall within the Case III charge unless they represent "pure profit income". But none of the authorities cited to me clearly establishes the converse proposition that all royalty payments representing "pure profit income" fall within the Case III charge, or indeed that they are capable of falling within this charge. Fortunately, however, I do not think it necessary to decide this point, because it is in my judgment only very marginally relevant to the point which falls for decision in this case, for the following reasons. Even if RXL were to satisfy me that the relevant payments constituted "any . . . other annual payment" of the nature referred to in Case III(a) set out in s 123(1) of the Income Tax Act 1952, I cannot see that this would assist greatly in the construction of the phrase "annual payment" as it appears in a provision in a different Act, namely the Finance Act 1965. In my judgment, a more reliable guide is to be found in the wording of the Finance Act 1965 itself. In my judgment, Mr. Potter is right in submitting on behalf of the Crown that this Act should be used as a dictionary for present purposes and that, particularly since liability to corporation tax is thereby imposed by reference to capital gains tax and income tax, it is legitimate to refer to corporation tax phraseology contained in the 1965 Act in order to determine what the Legislature intended in using the phrase "annual payment" in para 12(c). Section 52 of the Finance Act 1965 contains provisions for the allowance of certain charges on income for the purpose of computing corporation tax. For the purpose of this section, subss (2) and (3) contain a definition of certain payments which may be deductible, subs 3(a) reading as follows: "any yearly interest, annuity or other annual payment and any such other payments as are mentioned in section 169(3) of the Income Tax Act 1952, but not including sums falling within section 169(4) (rents, etc.)." Section 53(5)(b) contains similar phraseology. Sections 52(3)(a) and 53(5)(b) of the 1965 Act thus draw a specific distinction between "any yearly interest, annuity or other annual payment", on the one hand, and "any such other payments as are mentioned in section 169(3) of the Income Tax Act 1952", on the other hand. Reference to the wording of s 169(3) makes it clear that the "other payments" referred to in ss 52(3)(a) and 53(5)(b) of the 1965 Act are: D E F G H

"(a) any royalty or other sum paid in respect of the user of a patent; or (b) any rent, royalty or other payment which, under any of the provisions of this Act, is declared to be subject to deduction of tax under this Chapter as if it were a royalty or other sum paid in respect of the user of a patent." I

(1) 38 TC 240.

(2) 9 TC 392.

(Slade J.)

- A It may be added that s 169 itself draws the like distinction between an “annual payment” and a “royalty paid in respect of the user of a patent” as that drawn by ss 52(3)(a) and 53(5)(b) of the 1965 Act, because s 169(1) deals with the case of “any yearly interest of money, annuity or other annual payment” in clear distinction from payments of the nature mentioned in s 169(3). The 1952 Act thus contains at least one precedent for this distinction.
- B Mr. Nolan pointed out that the purpose of s 169(3) is to improve the machinery for collecting tax, and that it is not a charging section at all. He referred me in this context to the judgment of Sir Wilfrid Greene M.R. in *Commissioners of Inland Revenue v. British Salmson Aero Engines, Ltd.*<sup>(1)</sup> 22 TC 29, at pages 41–2. This is no doubt true, but I do not think it really assists RXL in the present case. The crucial point is that, on my analysis of the
- C statutory provisions set out above, it is in my judgment clear that, in using the phrase “annual payment” in ss 52(3)(a) and 53(5)(b) of the 1965 Act, the Legislature did not regard it as including payments of the nature referred to in s 169(3) of the Income Tax Act 1952. In particular, it did not regard it as including “any royalty or other sum paid in respect of the user of a patent”. In my judgment, in ss 52(3)(a) and 53(5)(b) it used the phrase as bearing a
- D meaning *ejusdem generis* with the specific instances given, in the shape of “yearly interest” and “annuity”. I can see no sufficient reason for attributing to the phrase “annual payment” in the context of para 12(c) a wider meaning than it bears in ss 52(3)(a) and 53(5)(b) of the same Act. On the contrary, I think there are positive reasons for construing it as bearing the meaning which I think it bears in these two subsections, namely, that of annual payments *ejusdem*
- E *generis* to “yearly interest” and “annuity”. For it follows the two sub-para (a) and (b) of para 12, which themselves deal substantially with annuities or kindred payments. Even without the assistance of the references in ss 52(3)(a) and 53(5)(b), I would have been disposed to think that the phrase “annual payments” in para 12(c) should be construed as being *ejusdem generis* with the specific instances given in the immediately preceding sub-para (a) and (b).
- F This seems to me to be an essentially more reasonable intention to attribute to the Legislature, in enacting para 12(c), than an intention to include within its scope any payments constituting “pure profit income”. In no other context, so far as I am aware, does the concept of “pure profit income” have anything much to do with capital gains tax. Sections 52(3)(a) and 53(5)(b), however, seem to me to show reasonably clearly that in the Finance Act 1965 the Legi-
- G slature was intending to use the phrase “annual payment” in the same narrow sense which it bears in s 169(1) of the Income Tax Act 1952. I cannot see any justification for concluding that, in the context of para 12(c), it bears a special sense, different from that which it bears in any other place where it appears in the Finance Act 1965. It therefore remains to consider whether the relevant payments in the present case are “annual payments” in the narrow sense which this phrase bears in ss 52(3)(a) and 53(5)(b) of the Finance Act 1965 and s 169(1) of the Income Tax Act 1952. Mr. Nolan, as an alternative argument, submitted that they are “annual payments” even within this narrow sense. He submitted that they do not fall within s 169(3) of the 1952 Act on the grounds that they are not “royalties or other sums paid in respect of the user of a patent” and that, if they do not fall within s 169(3), they must fall within s 169(1). Section
- I 169(3), he submitted, is directed solely to a “hiring” situation, and not the case of an outright disposition or surrender such as the present, where, by the 1964 and 1967 agreements, RXL parted with all its interest in the relevant patents so far as they might be exploited in the relevant areas.

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(1) [1938] 2 KB 482.

(Slade J.)

The point is a short one, and no authorities were cited which really assist in its determination. Mr. Nolan, in another context, referred me to the decision in *Delage v. Nuggett Polish Co. Ltd.* (1905) 92 LT 682 which illustrates that it is possible for a capital asset to be sold in return for what may be called "annual payments". In that case, Phillimore J. held that the relevant payments (which seem to have been akin to royalties) were "annual payments" within the meaning of s 40 of the Income Tax Act 1853. Since, however, that section made no reference to royalties, he did not have to consider, and did not consider, whether they were "royalties" within the meaning of any statutory provision. In my judgment, the sums payable by Xerox to RXL under clause 4 of the 1964 and 1967 agreements are, according to the ordinary meaning of words, "royalties or other sums paid in respect of the user of a patent". If, instead of wholly surrendering its rights in the relevant patents in respect of the relevant areas, RXL had surrendered them for all but the last few days, the contrary proposition would surely have been unarguable. I cannot think that the position is altered, and the case taken out of s 169(3), merely because the surrender was an outright one, reserving no reversion. In the result, I conclude that RXL fails at the last hurdle which it must surmount in order to gain exemption under para 12(c), because it cannot show that the rights disposed of by it by the distribution in 1969 were rights to "annual payments" within the meaning of that phrase as used in that sub-paragraph. I must accordingly dismiss this appeal.

*Appeal dismissed, with costs. Case remitted to the Special Commissioners.*

The Company's appeal came before the Court of Appeal (Bridge and Buckley L.JJ. and Sir David Cairns) on 24, 25 and 26 April 1978 when judgment was reserved. On 12 May 1978 judgment was given against the Crown, with costs.

*Michael Nolan Q.C.* and *A. R. Thornhill* for the Company.

*D. C. Potter Q.C.* and *Brian Davenport* for the Crown.

The following cases were cited in argument in addition to those referred to in the judgment:—*Stock v. Frank Jones (Tipton) Ltd.* [1978] 1 WLR 231; *British Commonwealth International Newsfilm Agency v. Mahany* 40 TC 550; [1963] 1 WLR 69; *Jones v. Commissioners of Inland Revenue* 7 TC 310; [1920] 1 KB 711; *Commissioners of Inland Revenue v. British Salmson Aero Engines, Ltd.* 22 TC 29; [1938] 2 KB 482; *Carson v. Cheyney's Executor* 38 TC 240; [1959] AC 412; *Wild v. Ionides* 9 TC 392; *Jarvis v. Curtis Brown Ltd.* 14 TC 744; *Westminster Bank Executor and Trustee Co. (Channel Islands) Ltd. v. National Bank of Greece S.A.* 46 TC 472; [1971] AC 945.

**Buckley L.J.**—I have asked Bridge L.J. to read the judgment of the Court.

**Bridge L.J.**—The question at issue in this appeal is whether an amount was rightly included in the assessment to corporation tax on the appellant taxpayer company, Rank Xerox Ltd. ("RXL"), for the accounting period of twelve months to 30 June 1970 as representing a chargeable gain accruing to RXL on

(Bridge L.J.)

- A the disposal of certain assets in December 1969. RXL appealed against the assessment to the Commissioners for the Special Purposes of the Income Tax Acts. The Commissioners dismissed the appeal. From this decision an appeal by Case Stated to the High Court was in turn dismissed by Slade J. RXL now appeals to this Court. The question raised for decision at all levels has been that of liability only. The amount of the chargeable gain, if there was one, will depend on difficult questions of valuation which happily are for another day.
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By s 238 of the Income and Corporation Taxes Act 1970 the profits of companies on which corporation tax is charged include chargeable gains as well as income and s 265 provides, so far as relevant for present purposes, for the computation of chargeable gains in accordance with the principles applying for capital gains tax, which are to be found in Part III of the Finance Act 1965. It is common ground both that the rights the subject of the present dispute are assets to which s 22 of the Act of 1965 applies and that there was in December 1969 a disposal of those assets by RXL. It follows from the application of the provisions of s 22(9) and (10) and s 23(1) and (2), that, subject to the valuation question, there was a chargeable gain (or an allowable loss) accruing to RXL on that disposal unless the rights in question fall within the provisions of Sch 7, para 12(c), which enacts:

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“No chargeable gain shall accrue to any person on the disposal of a right to, or to any part of . . . annual payments which are due under a covenant made by any person and which are not secured on any property.”

The Special Commissioners decided that the rights in question were to “annual payments”, but that the payments were not “due under a covenant”. The learned Judge decided that the payments were “due under a covenant”, but were not “annual payments”. Thus both arrived at the same result by precisely contrary routes.

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To do justice to the arguments it is necessary to examine the commercial history leading to the 1969 disposal of assets in some detail. In 1956 the Rank Organisation Ltd. and a subsidiary of that company agreed with the Xerox Corporation (“Xerox”), then known as The Haloid Company, to engage in a joint venture for the world wide exploitation, outside the United States of America and Canada, of the reproduction process known as xerography. RXL was the company which was to be, and was, formed to implement the agreement. Under the agreement Xerox were to transfer to RXL all patents, patent applications and licence rights relating to the process in those parts of the world to which the agreement related. The relevant patents granted, patent applications pending and licence rights subsisting at the date of the agreement were set out in a schedule to the agreement. After RXL had been formed an agreement was entered into on 1 May 1957 between Xerox and RXL which was called a licence agreement. This recited the 1956 agreement already referred to and provided that pursuant to that agreement Xerox granted to RXL an exclusive licence to use the inventions comprised in the letters patent and an exclusive sub-licence to use the inventions comprised in the licence rights set out in the schedule to the 1956 agreement. The licence agreement included a provision obliging Xerox to secure an assignment to RXL of the scheduled letters patent and patent applications on obtaining title thereto and the right to grant title. There is no finding in the Case as to what, if any, assignments were ever made pursuant to this provision. The combined effect of the 1956 and 1957 agreements, under provisions to which we need not refer in detail, was to impose upon the parties mutual obligations to exchange all information and know-how with respect to

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improvements and developments in the process of xerography and presumably, in so far as it was thought appropriate to protect such improvements and developments by patent applications, the necessary applications in countries outside the United States of America and Canada would have been made by RXL. The 1957 licence agreement continued in force until 1964. During this period, in the commercial exploitation of the process of xerography, Xerox had the field to themselves in the United States of America and Canada, RXL had the field to themselves in the rest of the world. But in 1964 the parties agreed to a radical change in this state of affairs. In effect Xerox took over the entire business of RXL in Central and South America and thenceforth had the field to themselves in the whole of the Americas. In 1967 a further change was effected whereby Xerox similarly took over from RXL the territory of the West Indies. The agreements concluded in 1964 and 1967, whereby these changes were given effect, are the crucial documents in the case, since it is the nature of the right to the payments due from Xerox to RXL under these agreements on which the appeal depends. For the purpose of deciding the questions in issue there is no material difference between the two agreements and it will suffice for the purposes of this judgment to consider the first agreement dated 20 February 1964.

The 1964 agreement uses some rather complex geographical formulae to indicate its area of operation, but we shall for brevity substitute the simple, if not entirely accurate, term "Latin America". Clause 1 provides:

"RXL hereby sells, assigns and transfers to Xerox its entire right, title and interest in all property, rights and assets in (Latin America) of whatsoever nature and description, excluding only its stock in Rank Xerox in Mexico, S.A. and including, without limitation, its goodwill, technical information, know-how, trade secrets, customer lists, patents, patent applications, rights to apply for patents, trade marks and trade mark applications."

The effect of clause 2 is to amend the 1957 licence agreement so as to exclude Latin America from its ambit. Clause 3 provides:

"All licences and sub-licences applicable to any place in (Latin America) heretofore granted by Xerox to RXL, and any right of RXL under paragraph one of the licence agreement to a licence or sub-licence applicable to any place in (Latin America) are hereby cancelled and released."

Clause 4 provides: "In consideration of the premises, Xerox shall pay or cause to be paid to RXL a royalty of 5% of Net Sales in (Latin America)." "Net Sales" are then defined by reference to "sales and rentals of xerographic machines, equipment, apparatus, paper and supplies". And then, continuing the quotation from clause 4:

"Such royalty payments shall be made or caused to be made by Xerox quarter-annually in the currency of the country in which the xerographic machines, equipment, apparatus, paper and supplies are delivered, except that where the existing laws of any country specifically authorise payment in pounds sterling, royalties with respect to such country may, at the option of Xerox, be paid in pounds sterling in London."

Clause 6 provides: "This agreement is made in England and shall be construed in accordance with English law." The agreement was executed under seal by Xerox.

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- A To complete the story, in December 1969 RXL declared a dividend of £8,400,000 to be satisfied by the distribution to shareholders *in specie*, as it is put, of the right to receive payments from Xerox under the provisions of clause 4 of the 1964 and 1967 agreements (“the Xerox payments”). Since there is, as we have already indicated, no dispute that this was a disposal of assets for capital gains tax purposes it is unnecessary to say more of the details of this transaction.
- B The two questions for decision, then, are whether the Xerox payments are “annual payments” and whether they are “due under a covenant” within the meaning of para 12(c) of Sch 7 to the Finance Act 1965. This paragraph is grouped with paras 11 and 13 under the heading “Debts and interests in settled property”. In our judgment neither the group heading nor the provisions of the companion paragraphs in the group throw any conceivable light on the meaning of para 12(c). Paragraph 12 as a whole reads:
- C “No chargeable gain shall accrue to any person on the disposal of the right to, or to any part of—(a) any allowance, annuity or capital sum payable out of any superannuation fund, or under any superannuation scheme, established solely or mainly for persons employed in a profession, trade, undertaking or employment, and their dependents, (b) an annuity granted otherwise than under a contract for a deferred annuity by a company as part of its business of granting annuities on human life, whether or not including instalments of capital, or an annuity granted or deemed to be granted under the Government Annuities Act, 1929, or (c) annual payments which are due under a covenant made by any person and which are not secured on any property.”
- D We do not find even this immediate context in the least illuminating. It cannot in our judgment be legitimate, as was suggested by Mr. Potter for the Crown, to look at the narrow and specific character of the categories of payment under (a) and (b) and to treat this as a ground for imposing some limitation on the language of (c) in order to confine it within comparably narrow and specific limits. Certainly it is not possible to apply the *ejusdem generis* rule. If the categories of payment in (a) and (b) can be fitted into a single genus, which we very much doubt, it would be too narrow to accommodate the language of (c) at all. Finally, to add one more negative observation, there is no help to be had in construing any exempt category of right under para 12 from the supposition that in enacting the exemption Parliament’s primary intention was benevolently to excuse the taxpayer disposing of such a right from liability to a chargeable gain, for it may equally well have been the primary intention, less benevolently, to deny him the benefit of any allowable loss. Accordingly we find ourselves in a singularly bleak and featureless stretch of statutory territory, with nothing to help us choose the right direction save the bare and cryptic words on the statutory signpost which fall to be interpreted. The phrase “annual payments” has, of course, long been familiar in taxing statutes, albeit in a particular context.
- G In current legislation it is found, among charging provisions, in Case III of Schedule D in s 109 of the Income and Corporation Taxes Act 1970, which charges tax in respect of “any interest of money, whether yearly or otherwise, or any annuity or other annual payments” and, among machinery provisions, in s 52(1) of the same Act which requires deduction of tax at source by the payer of “any annuity or other annual payment”. The origin of these provisions
- I can be traced as far back as s 102 of the Income Tax Act 1842, so it is not surprising to find that the phrase “annual payments” has frequently been judicially considered and has acquired, in what we shall call the Schedule D context, a particular meaning. It is common ground in this appeal that the basic

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characteristics which have been held necessary for the identification of an “annual payment” in the Schedule D context must also be taken to characterise an “annual payment” in the provision we have to construe. What the relevant characteristics are may conveniently be summarised by quoting extracts from the judgment of the Court of Appeal delivered by Jenkins L.J. in *Commissioners of Inland Revenue v. Whitworth Park Coal Co. Ltd.*(1) 38 TC 531. He said, at page 548:

“There have been many judicial pronouncements as to the scope of Rule 1(a) of Case III and the following propositions can be regarded as established. (i) To come within the Rule as an ‘other annual payment’ the payment in question must be *ejusdem generis* with the specific instances given in the shape of interest of money and annuities: see *Hill v. Gregory*(2) 6 T.C. 39, per Hamilton J., at page 47; *Earl Howe v. Commissioners of Inland Revenue*(3) 7 T.C. 289, per Scrutton L.J., at page 303 . . . (ii) The payment in question must fall to be made under some binding legal obligation as distinct from being a mere voluntary payment; see *Smith v. Smith* [1923] P. 191, per Lord Sterndale M.R., at page 197 and Warrington L.J. at page 202 . . . (iii) The fact that the obligation to pay is imposed by an order of the Court and does not arise by virtue of contract does not exclude the payment from Rule 1(a) of Case III. (iv) The payment in question must possess the essential quality of recurrence implied by the description ‘annual’. But that description has been given a broad interpretation in the authorities. For example, in *Smith v. Smith*, at page 201, Warrington L.J. said: ‘Again the fact that the payment is to be made weekly does not prevent it being annual provided the weekly payments may continue beyond the year’ . . . (v) The payment in question must be in the nature of a ‘pure income’ profit in the hands of the recipient.”

The first and fifth factors mentioned in this enumeration are really two sides of the same coin. The same principle underlies them both. It is stated in a well-known passage from the judgment of Scrutton L.J. in *Earl Howe v. Commissioners of Inland Revenue* [1919] 2 KB 336, who said at page 352(4):

“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 5 years for the hire and upkeep of a car, no one suggests that 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.”

Another statement of the principle is found in the judgment of Sir Wilfrid Greene M.R. in *In re Hanbury* 38 TC 588, at page 590, where he said:

“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. Payment 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

(1) [1961] AC 31.

(2) [1912] 2 KB 61.

(3) [1919] 2 KB 336.

(4) 7 TC 289, at p 303.

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A 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 makes 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."

Before the Special Commissioners it was contended for the Crown that Xerox payments were not pure profit income but were part of the trading receipts of RXL. In a Supplemental Case Stated, confirming their finding in the original Case that the Xerox payments were "annual payments" within the meaning of the relevant provision, the Special Commissioners rejected this contention and stated that "in reaching this determination we concluded that they were not trading receipts of RXL but could properly be called 'pure profit income' ". Before the Judge the Crown did not pursue the contention that the Xerox payments were trading receipts and we must take the finding that they were pure profit income to be now beyond challenge. The principal argument for the Crown now pursued, and that which persuaded the learned Judge that the Xerox payments are not "annual payments" under para 12(c), is that one may use certain provisions found in Part IV of the Finance Act 1965 to construe the phrase "annual payments" in para 12(c) and by so doing find that "any royalty or other sum paid in respect of the user of a patent" cannot be an "annual payment". It is said that the Xerox payments were "paid in respect of the user of" patents, and therefore cannot be "annual payments". The provisions relied on are concerned with the machinery for the collection of tax and require or permit those liable to make certain classes of payment to deduct and to account to the Revenue for the relevant tax. In relation to corporation tax ss 52 and 53 of the Act of 1965 incorporate, by reference, s 169 of the Income Tax Act 1952, the statutory predecessor of s 52 of the Income and Corporation Taxes Act 1970. Both s 169 of the Act of 1952 and s 52 of the Act of 1970 provide in separate subsections for the deduction of tax by the payer from, on the one hand, "annual payments" within Case III of Schedule D and, on the other hand, "any royalty or other sum paid in respect of the user of a patent". Were the Xerox payments payable "in respect of the user of a patent"? Clearly they cannot have been so in their entirety because under the 1964 and 1967 agreements RXL transferred to Xerox a great deal more than the mere right to the user of patents. Some, but we know not what, fraction of the benefits conferred on Xerox for which the payments were the consideration may have taken the form of the outright assignment of rights then vested in RXL or the surrender of licences then enjoyed by RXL in respect of any patents which may then have been in force in any part of Latin America or the West Indies. After the agreements were concluded RXL no longer had any interest in any of these patents and the patents became the absolute property of Xerox. Moreover the "royalties" payable under clause 4 were not confined to sales in the countries in which any relevant patents were in force, nor to sales of apparatus protected by any such patents, nor to sales during the life of any such patents. In these circumstances it would in our judgment be a misuse of language to describe the Xerox payments as being made "in respect of the user of a patent".

This conclusion is sufficient to refute the main argument for the Crown which Slade J. accepted. But suppose that, contrary to this view, the Xerox payments were made "in respect of the user of a patent". Does it then follow from a consideration of s 169 of the Income Tax Act 1952, as applied by ss 52 and 53 of the Finance Act 1965, that a payment "in respect of the user of a

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patent" cannot be an "annual payment"? Put in another way, are the categories of "annual payments" within Case III of Schedule D and payments "in respect of the user of a patent" to be regarded for all purposes as mutually exclusive because they are the subject of separate provisions in the machinery for the collection of tax? In the great majority of cases patent royalties will not fall within Case III of Schedule D because, being trade or professional receipts taxable under Case I or Case II, they will lack the quality of being pure profit income in the hands of the payee. They have nevertheless been treated similarly to Case III payments under the tax legislation by a provision originating in s 25 of the Finance Act 1907, and now found in s 52(2) of the Income and Corporation Taxes Act 1970, authorising deduction of tax by the person liable to make the payments. This provision certainly applies to patent royalty payments whether they are "annual payments" or not, but we find it impossible to infer from the presence of this provision that payment of a patent royalty is incapable of being an "annual payment" within Case III if it otherwise exhibits the necessary characteristics to make it so. We would therefore answer in the negative the two questions posed at the beginning of this paragraph and on this ground also reject the argument that the Xerox payments are excluded from the category of "annual payments" under para 12(c) by an interpretation derived from s 169 of the Income Tax Act 1952 as applied by ss 52 and 53 of the Finance Act 1965.

Independently of these particular statutory provisions Mr. Potter has advanced a wider argument for the Crown to the effect that payments which can properly be described as royalties, whether the term is used strictly to describe receipts derived from patents or copyrights or in some broader sense as in clause 4 of the 1964 and 1967 agreements, cannot in their very nature qualify as "annual payments". He submits that in a case in which royalties, for any reason, were not taxable under Case I or II of Schedule D, they would be taxed not as "annual payments" under Case III but under the residual Case VI. There is no authority directly in point. Counsel on both sides referred to authorities which, it was suggested, bear upon this question indirectly, but we can derive so little assistance from these that we excuse ourselves from discussing them in this judgment. The question must, we think, be decided as one of principle. The argument of principle by which Mr. Potter seeks to support his proposition is that royalties, in any sense of the term, must represent payments for the exploitation of what he calls "intellectual property" and they are thus, so he argues, analogous to payments of hire for the use of chattels. The answer to this argument lies, in our judgment, in the realisation that it is really an attempt to re-introduce by the back door the contention rejected by the Special Commissioners that the Xerox payments are not pure profit income but trade receipts. Mr. Potter submits that the nature of royalty payments cannot vary according to the particular circumstances in which they are payable. We cannot agree. We accept that in normal circumstances royalty payments will not be pure profit income because, in the language of Sir Wilfrid Greene M.R. in *In re Hanbury*(1) the proper way to treat them will be "as an element to be taken into account in discovering what the profits of the recipient are". But this need not necessarily be so and, when the position of the payee is such that his absolute entitlement to receive the payments is wholly independent of any outgoings or expenses to which he may be liable we can see no reason in principle why the payments should not be, as the Special Commissioners found that the Xerox payments in this case were, pure profit income and therefore "annual payments".

(1) 38 TC 588, at p 590.

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- A The final argument for the Crown which needs to be considered in relation to the question of "annual payments" is the submission that the Xerox payments would be taxable under Case V of Schedule D as "income arising from possessions out of the United Kingdom" and on that account cannot fall within Case III as "annual payments". We do not find it necessary to decide the question, which does not appear to have been raised before the Special Commissioners, whether the Xerox payments are "income arising from possessions outside the United Kingdom" or, if they are, whether in an issue arising directly under Schedule D the appropriate Case under which they should be charged is Case III or Case V. For while we accept that "annual payments" under para 12(c) must exhibit the same general characteristics as in the Schedule D context, we do not think it at all follows that a payment having those characteristics cannot qualify as an "annual payment" under para 12(c) solely because it would fall to be charged under Schedule D under a different Case from Case III for reasons unconnected with and not affecting its character as an "annual payment".

- Accordingly, on the first main point in the appeal we conclude, in agreement with the Special Commissioners, and respectfully differing from the learned Judge, that the Xerox payments were "annual payments". Were they "due under a covenant"? The category of "annual payments" being as wide as it is, it is difficult not to think that the words "due under a covenant" were introduced into para 12(c) with the object of narrowing the class of payments to which the exemption was to apply. It is tempting therefore immediately to speculate as to what may have been the rationale of the limitation intended to be imposed by these words. Mr. Potter's submission for the Crown is that the only reading which makes sense is to construe the phrase as applying to payments made without consideration which are enforceable only because covenanted by deed. We have been much impressed by this submission. Although, as the learned Judge observed<sup>(1)</sup>, "there is no general principle of capital gains tax which exempts a disponent from tax on a chargeable gain arising on a disposition simply because he originally acquired the subject matter of the disposition through another's gift", there is nothing fanciful in supposing that Parliament, in relation to the familiar category of gratuitous covenanted annual payments to relatives, dependants and the like, may have thought it convenient to exclude any chargeable gain or allowable loss which would otherwise accrue on the disposal of the asset, particularly perhaps on the death of the covenantee or the release of the covenant. On the other hand if para 12(c) is capable of embracing a whole range of "annual payments" of a purely commercial character, as for instance the Xerox payments in this case, provided the obligation to pay is undertaken by deed, it is impossible to conceive of any rational fiscal policy underlying the statutory exemption. The essential character of such payments depends on the commercial realities of the transaction. Whether the instrument under which the payments are due was executed by the party liable under hand or under seal is, one would have supposed, from the fiscal point of view wholly irrelevant. In the light of these considerations we have no doubt at all that if the statutory language is reasonably capable of two meanings, one being that for which the Crown contends, that is the meaning we should prefer. We make no secret of the fact that we have tried hard to discover just such an ambiguity, but in the end we find ourselves defeated in the attempt. By itself the word "covenant" is admittedly ambiguous in that it is capable, in certain contexts, of embracing promises not under seal, but that does not assist,

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(1) Page 200 *ante*.

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since in the context of para 12(c) "covenant" clearly bears its ordinary and primary meaning of a promise in a document executed by the promisor under seal. Mr. Potter has argued that there is ambiguity in the phrase "payment due under a covenant" and that this is capable of meaning a payment due by virtue of a covenant alone, i.e. a payment unsupported by consideration. The insuperable obstacle to this interpretation is that once a promise to pay is embodied in a deed executed by the payer, then, notwithstanding that there may have been valuable consideration given for the promise, the debt arising on the promise is due as a specialty debt and not as a simple contract debt; in other words it is a "payment due under a covenant" and nothing else. As was said by Jervis C.J. in *Abley v. Dale* (1850) 20 LJCP 33, at page 35:

"if the precise words used are plain and unambiguous, we are bound to construe them in their ordinary sense, even though it does lead to an absurdity or manifest injustice. Words may be modified or varied where their import is doubtful or obscure, but we assume the functions of legislators when we depart from the ordinary meaning of the precise words used, merely because we see, or fancy we see, an absurdity or manifest injustice from an adherence to their literal meaning."

To give to the words "due under a covenant" the meaning for which the Crown contends requires that other words be added, but "we are not entitled to read words into an Act of Parliament unless clear reason for it is to be found within the four corners of the Act itself"; *per* Lord Loreburn L.C. in *Vickers, Sons & Maxim Ltd. v. Evans* [1910] AC 444, at page 445. We can find no clear reason in the Finance Act 1965 for reading words into para 12(c). The words Parliament has used are capable of only one meaning and according to that meaning the Xerox payments are "due under a covenant".

We therefore allow the appeal and discharge so much of the assessment to corporation tax under appeal as related to the disposal by RXL of the right to receive the Xerox payments.

*Appeal allowed, with costs. Leave to appeal to the House of Lords granted.*

The Crown's appeal against the above decision came before the House of Lords (Lords Keith of Kinkel, Russell of Killowen, Salmon and Wilberforce and Viscount Dilhorne) on 10 and 11 July 1979 when judgment was reserved. On 25 October 1979 judgment was given in favour of the Crown, with costs.

*D. C. Potter Q.C., J. A. D. Hope Q.C. and Brian Davenport* for the Crown.

*Michael Nolan Q.C., J. Murray Q.C. and A. R. Thornhill* for the Company.

The following cases were cited in argument in addition to those referred to in the speeches:—*Stock v. Frank Jones (Tipton) Ltd.* [1978] 1 WLR 231; *Delage v. Nugget Polish Co. Ltd.* (1905) 92 LT 682; *Jones v. Commissioners of Inland Revenue* 7 TC 310; [1920] 1 KB 711; *Scottish Farmers' Dairy Co. (Glasgow), Ltd. v. M'Ghee* 1933 SC 148.

A **Lord Wilberforce**—My Lords, this appeal is concerned with the capital gains tax. It turns upon Sch 7, para 12 to the Finance Act 1965 which provides that:

“No chargeable gain shall accrue to any person on the disposal of a right to, or to any part of . . . (c) annual payments which are due under a covenant made by any person and which are not secured on any property.”

B The payments which were, admittedly, disposed of by the Appellant Company arose out of two agreements made in 1964 and 1967 by which, in consideration of the assignment by the Appellant Company to a U.S. company, now called Xerox Corporation, of certain patents, other rights, goodwill and know-how in defined territories, Xerox agreed to make the payments. The relevant clause in the agreement of 1964 read as follows:

C “4. In consideration of the premises, Xerox shall pay or cause to be paid to Rank Xerox a royalty of 5% of Net Sales in the Western Hemisphere with the exception of the United States of America, its territories and possessions, and Canada.”

The agreement of 1967 contained a clause in similar terms. Each of these agreements was executed by Xerox under seal. So it is contended that the

D payments satisfy the words “annual payments which are due under a covenant”, so that capital gains is not chargeable. The Court of Appeal (reversing Slade J.) has so decided<sup>(1)</sup>.

My Lords, there can surely be no doubt that to bring the payments which arose to the Appellant under the agreements of 1964 and 1967 within the exemption conferred by para 12(c) is paradoxical. If the signature of Xerox to these agreements had not been under seal, the Appellant Company’s liability to capital gains tax in respect of the payments could not have been disputed. To make their liability depend upon a circumstance so inessential and immaterial as the affixing, or absence, of a seal is arbitrary in the extreme. As a matter of substance it is impossible to detect any reason of fiscal policy why the affixing of a seal to an agreement should have any relevance to the imposition of the tax.

F Now the intention of Parliament, in taxation matters, may sometimes be inscrutable or obscure, but we should hardly attribute to it so great a degree of arbitrariness as the decision of the Court of Appeal involves. If any reasonable meaning can be found for the words in question which would avoid this, that meaning should be accepted. And I do not have great difficulty in finding one. It can be accepted that the primary meaning of “covenant” is a promise by deed.

G As a secondary meaning the word may be applied to any promise or stipulation, whether under seal or not (Stroud’s Judicial Dictionary, 4th edn s.v. “covenant”). It can equally be accepted that in a statute, including a taxing statute, a word should be given its primary meaning unless something in the context, or in the history of the enactment, or the reasons for the enactment, indicates otherwise.

H But what has to be interpreted is not merely the word “covenant”, but the whole phrase “annual payments which are due under a covenant made by any person”. As a matter purely of grammar the words “due under” and “made by any person” suggest to me a unilateral promise which is enforceable in spite of the absence of consideration. They are not apt to refer to a bilateral agreement in which the annual payments are consideration for some obligation undertaken by the payee. There is a further argument which supports what is so far a tentative interpretation. It has become for at least 50 years a well-known practice

I for individuals to promise to make annual payments to their dependants or to

(1) Page 204 *ante*. [1979] Ch 113.

**(Lord Wilberforce)**

charities. These transactions have acquired in both popular and legal parlance the description “annual payments under covenant”, or “seven year covenants”. Charities when appealing for money invariably invite supporters to enter into a covenant—meaning a voluntary promise to pay, for a period. And this practice, and its nomenclature, has been recognised by fiscal legislation. I shall not trace this historically: it is sufficient to refer to the codifying Income and Corporation Taxes Act 1970.

Annual payments under covenant are dealt with by s 434 which, effectively, lays down the seven-year rule. The relevant wording is:

“(1) Any income which, by virtue or in consequence of any disposition made . . . by any person . . . for a period which cannot exceed six years . . .” and “. . . ‘disposition’ includes any trust, covenant, agreement or arrangement.”

So if one reads “covenant” into subs (1) in place of “disposition” the enactment becomes “any income which, by virtue or in consequence of any covenant made . . . by any person”—language which is very close to the phrase in Sch 7, para 12(c), which, as it appeared in the Income Tax Act 1952, the draftsmen of the latter must have had in mind. The word “covenant” again appears in s 441(1) in the definition of “settlement”. Similarly in ss 445ff, we find references to annual payments payable by virtue or in consequence of any provision of the settlement—the latter word again including “covenant” (s 454(3)). By contrast, s 457 refers to annual payments made under a partnership agreement, being payments made under a liability incurred for full consideration—clearly treated as a different case. So “covenant” in this part of the Act has a clear and special meaning, corresponding to practice, of a unilateral and voluntary enforceable promise as distinguished from an “agreement” supported by consideration. Mr. Nolan, for the Company, whose experience in these matters is very great, was only able to point to one place in the Act of 1970 where “covenant” has a different meaning, namely to s 34. There, the marginal note refers to restrictive “covenants” but the text of the section refers to “undertaking”—confirming, to my mind, that “covenant” in the Act bears a special sense not extending to an obligation under a bilateral agreement. Assuming, therefore, that the word “covenant” is to be interpreted as necessarily involving a seal, the manner in which it is used in the income tax legislation, conforming to practice, would suggest that it should be understood as referring only to unilateral promises of a voluntary character. This might, it is true, exclude promises to make annual payments contained in a marriage settlement or a separation or divorce agreement, but such cases are unlikely to involve capital gains tax. If this is right, that would exclude the contractual and bilateral agreement in the present case.

There are two further points which deserve mention. First, it was said for the Crown that a distinction is to be made in the legislation—specifically in the Finance Act 1965—between annual payments and royalties or other sums in respect of the user of a patent. The payments in the present case were, it is said, of the latter character, and so for this reason, not within para 12(c). In the view which I take of the meaning of para 12(c) it is not necessary to decide this point.

Secondly, since the Finance Act 1965, as all Finance Acts, is a United Kingdom statute, applicable to Scotland as well as to England and Wales, it was argued that it should be given an interpretation which would produce a similar effect in both parts of the Kingdom. This is certainly in accordance with principle and with authority (see *Lord Advocate v. Anna, Countess of Moray*

(Lord Wilberforce)

A [1905] AC 531; *Commissioners for General Purposes of Income Tax for City of London v. Gibbs*(1) [1942] AC 402). In Scotland no distinction is made between contracts under seal, which are valid without consideration, and other contracts which require consideration, though for purposes of proof gratuitous may differ from onerous obligations.

My Lords, this type of problem received attention in *Pemsel's case*(2) [1891] AC 531 in connection with the word "charitable" and was the subject of observations by more than one of their Lordships. It was pointed out by Lord Macnaghten that statutes which apply to Scotland as well as to England may be divided into three classes: first, those which avoid the use of legal terms, second, those in which an English expression is followed by its Scottish counterpart. In the third, in which the Income Tax Acts may be included, the drafting is English with perhaps some Scottish phrases casually thrown in. In such cases, he said, you must take the meaning of legal expressions from the country to which they belong, and in any case arising in the sister country you must apply the statute in an analogous or corresponding sense. I think that this is the right course here. "Covenant" should be given its English meaning in England, viz., of a promise under seal; in Scotland, the phrase should be understood as referring to enforceable gratuitous promises. We are indeed told that promises in favour of charities, though made simply in writing, may be referred to as covenants. There is therefore no difficulty in construing para 12(c) so as in either part of the Kingdom to exclude the agreements in question.

I would allow the appeal.

**Viscount Dilhorne**—My Lords, I have had the advantage of reading in draft the speeches of my noble friends, Lord Wilberforce and Lord Russell of Killowen. I agree with them and there is nothing that I can usefully add. For the reasons they state I would allow the appeal.

**Lord Salmon**—My Lords, since 1956 Rank Xerox has done a great deal of business with a U.S.A. company now named Xerox Corporation. In 1964 Rank Xerox entered into a written contract, governed by English law, with Xerox Corporation which contained two clauses of importance to this appeal. They read as follows:

"1. Rank Xerox hereby sells, assigns and transfers to Xerox its entire right, title and interest in all property, rights and assets in the Western Hemisphere [as defined] . . . including, without limitation, its goodwill, technical information, know-how, trade secrets, customer lists, patents . . .  
G 4. In consideration of the premises, Xerox shall pay or cause to be paid to Rank Xerox a royalty of 5% of Net Sales in the Western Hemisphere with the exception of the U.S.A. . . . and Canada . . ."

In 1967 a similar contract was entered into between the same parties relating to sales in what was then the British West Indies. Both these contracts were typical commercial contracts. Each of them however happened to be executed by Xerox under seal. The contracts would, of course, have been equally effective had they not been executed by either party under seal. On 11 December 1969 Rank Xerox passed a resolution to pay its shareholders a dividend of £8,400,000

(1) 24 TC 221 (*sub nom.* Rex v. General Commissioners for City of London (*ex p.* Gibbs)).

(2) 3 TC 53.

**(Lord Salmon)**

by distributing *in specie* its rights to receive annual payments under clause 4 A of the 1964 and 1967 contracts. An assessment to corporation tax in respect of the distribution to which I have referred was made against Rank Xerox for the accounting period of twelve months to 30 June 1970. This assessment was made because corporation tax falls to be charged on profits of the taxpayer and profits for this purpose include chargeable gains which for all purposes relevant to the present case fall to be computed in accordance with the principles applicable B to capital gains tax. See s 238(1) and (4)(a) and s 265 of the Income and Corporation Taxes Act 1970. Schedule 7, para 12(c) of the Finance Act 1965 provides that:

“No chargeable gain shall accrue to any person on the disposal of a right to, or to any part of— . . . (c) annual payments which are due under a covenant made by any person and which are not secured on any property.” C

Rank Xerox contended that no chargeable gain can have accrued to them on their disposal of their right to what they argue are “annual payments due under a covenant”. The Special Commissioners did not accept this argument. They found in favour of the Crown on the ground (a) that a chargeable gain had accrued to Rank Xerox on their disposal of their right to the annual payments due under the written agreements of 1964 and 1967 whether or not D they had been executed under seal and (b) that para 12(c) of Sch 7 refers only to a right to annual payments made not by a bilateral agreement but by a personal voluntary disposition of income by a deed of covenant.

Slade J., who did not agree with the reasons relied on by the Special Commissioners, nevertheless dismissed the appeal on the ground that Rank Xerox could not show that the rights disposed of by the distribution in 1969 E were rights to “annual payments” within the meaning of those words in para 12(c) of Sch 7. The Court of Appeal reversed the decision of Slade J. because they disagreed both with the reasons given by him and those given by the Special Commissioners in favour of the Crown. The Crown now appeals to your Lordships’ House.

The result of this appeal must depend upon whether or not para 12(c) of F Sch 7, or its true construction, applies to contracts such as those of 1964 and 1967 to which I have referred. If para 12(c) does apply to such contracts, it follows that should such contracts happen to be executed under seal by the party liable to make the annual payments, the disposal by the other party of the right to annual payments due under the contracts would escape tax, sometimes, as in G the present case, running into millions of pounds. If, on the other hand, the contracts had no seal upon them, having been signed in the ordinary way by each party, tax would be payable on the disposal of the rights to annual payments. This result is obviously absurd for whether or not it has a seal upon it makes no difference whatsoever to the effect or enforceability of the contract. Why should tax be payable if the contract is a simple contract but not payable H if the contract is executed under seal? No reason has been or could be advanced to justify the view that Parliament could have intended that its legislation should have such a bizarre result. It has submitted, however, that whatever the intention of Parliament may have been, the only possible meaning of para 12(c) is that the presence of a seal on the contract exempts the taxpayer from payment of the tax which would otherwise be exigible. The rules of interpretation to be I applied in the construction of taxing statutes were summarised by Lord Donovan

(Lord Salmon)

A in delivering the majority judgment of the Privy Council in *Mangin v. Inland Revenue Commissioner* [1971] AC 739, at page 746:

“First, the words are to be given their ordinary meaning... Secondly, ... ‘one has to look merely at what is clearly said. There is no room for any intendment. There is no equity about a tax. There is no presumption as to tax. Nothing is to be read in, nothing is to be implied.

B One can only look fairly at the language used’: *per* Rowlatt J. in *Cape Brandy Syndicate v. Inland Revenue Commissioners*(1) [1921] 1 K.B. 64, 71, approved by Viscount Simons L.C. in *Canadian Eagle Oil Co. Ltd. v. The King*(2) [1946] A.C. 119, 140. Thirdly, the object of the construction of a statute being to ascertain the will of the legislature it may be presumed that neither injustice nor absurdity was intended. If therefore a literal interpretation would produce such a result, and the language admits of an interpretation which would avoid it, then such an interpretation may be adopted.”

The primary meaning of “covenant” is a promise by deed. I recognise that, therefore, the words “due under a covenant” could in some contexts be interpreted as “due under any promise by deed”. This interpretation would however  
D lead to the absurd result which I have indicated if applied in the context of para 12(c).

This appeal does not turn upon the interpretation only of the words “due under a covenant” but on the interpretation of the words “annual payments which are due under a covenant made by any person”. These words are, in my view, singularly inept to cover annual payments under bilateral agreements  
E such as the agreements with which we are concerned. If that had been the intention of the Legislature, nothing would have been more natural or easier than to have said “annual payments due under an agreement”. It seems inconceivable to me that the Legislature intended to and did lay down (as, in effect, Rank Xerox contends) that no chargeable gain should accrue to any person on the disposal of a right to annual payments due under a business or indeed any  
F agreement—if but only if the agreement was executed under seal. There is no fiscal or any other reason for making the taxpayer’s liability to tax dependent upon whether or not the relevant agreement had a seal upon it. It would be utterly ridiculous to make liability to tax depend upon the existence of a seal. For these reasons the language of para 12(c) of Sch 7 is, in my opinion, wholly inconsistent with the meaning which Rank Xerox seeks to attribute to it. In  
G my view, it refers only to a unilateral promise made by deed which is therefore enforceable in spite of the absence of consideration: and the paragraph certainly has nothing whatsoever to do with business or any other bilateral agreements.

There exists and has existed for upwards of 50 years a well-known and widespread practice by which charities of all kinds, “family” and dependants have been supported by annual payments under deeds of covenant over specified  
H periods. Para 12(c) was, to my mind, designed to relieve beneficiaries under such covenants from any liability to tax on disposal of any of their rights to annual payments due under such covenants provided the annual payments were not secured on any property. Annual payments to charity were most unlikely to be so secured, although annual payments to “family” might be. The Finance Act 1965, like all Finance Acts, applies to the whole of the United  
I Kingdom. It was, I think, agreed by Counsel on each side that in Scotland

(1) 12 TC 358, at p 366.

(2) 27 TC 205, at p 248.

**(Lord Salmon)**

there is no such thing as a promise under seal, but there exist enforceable gratuitous promises in writing; and these when made in favour of charities, "family" or dependants, are, in Scotland, also commonly referred to as covenants. Para 12(c) would accordingly be construed alike in both parts of the U.K. A

Having regard to the conclusion at which I have arrived in relation to the true interpretation of para 12(c) of Sch 7, it is unnecessary to express any opinion on the point as to whether the royalties payable under clause 4 of the contracts of 1964 and 1967 are "annual payments" within the meaning of those words in para 12(c). B

My Lords, for the reasons I have stated, I would allow the appeal with costs here and in the Court of Appeal.

**Lord Russell of Killowen**—My Lords, this case raises a question on the liability of the taxpayer company to corporation tax on its profits. For that purpose its profits include what are chargeable gains for the purpose of capital gains tax. The taxpayer contends that the particular sums in question fall within para 12(c) of Sch 7 to the Finance Act 1965, which provides "No chargeable gain shall accrue to any person on the disposal of a right to, or to any part of— . . . (c) annual payments which are due under a covenant made by any person and which are not secured on any property". Two questions were and are raised for decision. First: whether the relevant payments, the right to which was disposed of, were "annual payments". Second: whether they were "due under a covenant made by any person". Slade J.<sup>(1)</sup> ([1978] Ch 1) held that they were due under a covenant, but that they were not annual payments, and so decided against the taxpayer. The Court of Appeal<sup>(2)</sup> ([1979] Ch 113) reversed Slade J. holding in favour of the taxpayer that they were both "annual payments" and "due under a covenant". The Special Commissioners had concluded against the taxpayer that though they were annual payments they were not due under a covenant. C D E

In 1956 an agreement was entered into between three companies, one of which was Xerox Corporation, for the joint exploitation throughout the world (exclusive of Canada, the U.S.A. and certain other countries associated with the U.S.A.) of a reproduction process known as xerography: to incorporate for this purpose an English limited company—in fact the taxpayer—through which the business of such exploitation would be carried on: and to participate in the profits of the taxpayer on the basis there set out. Xerox Corporation agreed that it would transfer to the taxpayer when formed all its relevant patents, patent applications and licences then or thereafter owned in respect of the territory to be exploited: and the agreement scheduled a large number of such patents, applications and licences. In 1957 Xerox entered into a licence agreement with the taxpayer accordingly, though this took the form of exclusive licences and sub-licences rather than assignments. In 1964, by an agreement between Xerox and the taxpayer, the latter (in effect) sold, assigned and transferred to Xerox all its rights in all property, rights and assets in Central and South America including its know-how, patents, trade marks and so forth, thus surrendering to Xerox its rights to continue the exploitation of xerography in that area. In consideration of that Xerox agreed to pay "a royalty of 5% of Net Sales" (including hirings) of xerographic machines, equipment, apparatus, F G H

(1) Page 196 *ante*.

(2) Page 204 *ante*.

(Lord Russell of Killowen)

- A paper and supplies in that area. In 1967 a similar agreement was entered into between the taxpayer and Xerox in respect of the British West Indies. These two agreements were executed by Xerox by the affixing of its corporate seal. In 1969 the taxpayer resolved to pay to its shareholders a dividend of £8,400,000 to be satisfied by distribution *in specie* of its rights to receive payments from Xerox under the 1964 and 1967 agreements. This was clearly a disposal giving rise to a chargeable gain, unless within para 12(c) of Sch 7 it was a disposal of a right to annual payments due under a covenant.

I consider first whether the payments due from Xerox to the taxpayer can be within the phrase "due under a covenant made by any person" in that paragraph. I ask myself first why Parliament should have elected to single out for special treatment a commercial bargain such as was made in 1964 (and 1967) if, and only if, the person who undertook to make the payments happens to affix his or its seal to the agreement. Indeed, if the taxpayer is right, it need not be affixed to the agreement: by the simple expedient of a subsequent agreement under seal to carry out the terms of the original bargain (not under seal) a case could be steered into this paragraph shortly before a proposed disposal. There is, it is true, a difference in point of limitation period between action on a specialty and one on simple contract. But I apprehend that an action based upon the agreement by Xerox to pay the 5 per cent. royalty could not be defective for failure to plead that it was under seal. In my opinion "due under a covenant" is fairly to be construed as something narrower in scope than "due under an agreement" would have been. I construe the phrase as meaning due by reason of the fact that the promise is under seal, because of the existence of the seal. If the presence of the seal adds nothing to the obligation to make the annual payments, I do not consider that the payments were "due under a covenant made by any person". This construction is in my view legitimate as avoiding the wholly capricious outcome of exclusion or non-exclusion from chargeable gain depending on the chance of an unnecessary seal. It is of course true to say that this construction of the phrase narrows its application to cases of other than for valuable consideration, whether in favour of charity or individuals, the latter most commonly being in favour of members of the covenantor's family. It is also true to say that covenants in favour of charity would not be expected to be secured on property. But "family" covenants might well be so secured; and this exclusion from the exemption is presumably because the disposal would involve the disposal of the security.

- Argument on the Scots law was addressed to this House, and it appears that the English concept of a seal as constituting a covenant has no place in that law. But I decline to deduce from that fact that "due under a covenant" is to be read as "due under an agreement". Rather would I venture to suggest that in applying para 12(c) in Scotland it would be a suitable analogy to construe the phrase as limited to cases where the gratuitous nature of the undertaking to pay requires it to be evidenced by the writ of the undertaker. If that view of the scope of the phrase "due under any covenant by any person" is correct, it suffices to decide this appeal in favour of the Crown, and to allow it. The alternative contention for the Crown was that these payments were not annual payments because they were royalties in respect of the user of patents. I need not rehearse the closely reasoned arguments in support of that submission. In the end I was not convinced that, assuming the payments agreed to be made by Xerox were such royalties, that would be inconsistent with their being also annual payments.

**(Lord Russell of Killowen)**

Accordingly, I would allow the appeal with costs here and in the Court of Appeal and restore the order of Slade J. which remitted the case to the Special Commissioners for adjustment of the assessment. A

**Lord Keith of Kinkel**—My Lords, I agree with the speeches of my noble and learned friends Lord Wilberforce and Lord Russell of Killowen, which I have had the opportunity of reading in draft.

The appeal is concerned with the proper construction of the words “annual payments which are due under a covenant made by any person and which are not secured on any property”, which appear in para 12(c) of Sch 7 to the Finance Act 1965. In my opinion it is clear that the type of transaction intended to be indicated by the expression “covenant made by any person” is a unilateral binding obligation entered into without consideration, the binding character of which, under English law, depends on the affixing of a seal, and not any sort of agreement whatever which happens to have a seal affixed to it. B  
C

Counsel for the Appellant sought to reinforce his case by reference to the position under the law of Scotland, where the presence or absence of a seal is irrelevant to the binding force of any obligation. It was argued that para 12(c), being a fiscal enactment, must be construed so as to make the incidence of taxation the same both in England and in Scotland, and that if it were interpreted in an English case as meaning that the mere affixing of seal was to be the critical factor attracting the application of the paragraph, the same rule must apply to Scotland, which in view of the irrelevant nature of a seal there was absurd. It followed that such an interpretation must be incorrect. For the Crown, on the other hand, it was argued that a recognised secondary meaning of “covenant” in English law was “agreement”, and that this was the meaning of the word in Scots law. The adoption of this meaning would produce a result which was consistent with both English and Scots law and which was favourable to their case. D  
E

In my opinion reference to the law of Scotland is not of assistance for the purpose of construing para 12(c) in its application to the present case, which arises in England. The use of technical terms of English law is commonly found in fiscal legislation applicable to all parts of the United Kingdom. The correct approach to such terms was settled by the decision of this House in *Special Commissioners of Income Tax v. Pemsel* [1891] AC 531. Lord Macnaghten, at page 580, thus explained the position<sup>(1)</sup>: F

“You must take the meaning of legal expressions from the law of the country to which they properly belong, and in any case arising in the sister country you must apply the statute in an analogous or corresponding sense, so as to make the operation and effect of the statute the same in both countries.” G

Later he said:

“In construing Acts of Parliament, it is a general rule, not without authority in this House (*Stephenson v. Higginson*<sup>(2)</sup>) that words must be taken in their legal sense unless a contrary intention appears. Is a contrary H

<sup>(1)</sup> 3 TC 53, at p 94.

<sup>(2)</sup> (1852) 3 HLC 638, at p 686.

(Lord Keith of Kinkel)

- A intention shown merely by the circumstance that the legal meaning of the words used belongs more properly, or even exclusively, to the jurisprudence of one part of Great Britain? Agreeing with Lord Hardwicke” [in his well-known letter to Lord Kames] “rather than with the Court of Session” [in *Baird’s Trustees v. Lord Advocate* (1888) 15 R 682] “I am disposed to answer that question in the negative.”
- B I think it is clear that in para 12(c) “covenant” is to be read in its technical English meaning of a document under seal. But a proper construction of all the relevant words in their context leads to the conclusion that the type of transaction pointed to by the paragraph is that which I have described above. That conclusion having been reached in a case arising in England, there would be no difficulty, following the course mapped out by Lord Macnaghten, in arriving at a consistent result in a comparable Scottish case. The substance of the type of transaction covered by the paragraph is that it is a unilateral binding obligation. The form of such an obligation differs in England and in Scotland. In England it must be under seal, in Scotland no particular formality is required, but proof of the obligation is limited to the writ or oath of the granter. Through thus reasoning by analogy the application of the paragraph may be made the same in both countries. The use of the word “covenant” to describe an agreement of any sort is archaic in Scottish legal terminology. But in the context of annual payments the word is commonly applied, no doubt under English influence, to the familiar seven-year unilateral obligation in favour of relatives or charities, which often is, but need not necessarily be, in probative form.
- C
- D

My Lords, I would allow the appeal.

- E *Appeal allowed, with costs.*

[Solicitors:—Linklaters & Paines; Solicitor of Inland Revenue.]

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