IN THE COURT OF APPEAL (CIVIL DIVISION) **A2/2016/4109**

ON APPEAL FROM THE HIGH COURT OF JUSTICE, CHANCERY DIVISION, COMPANIES COURT (HILDYARD J)

IN THE MATTER OF LEHMAN BROTHERS INTERNATIONAL (EUROPE) (IN ADMINISTRATION)

AND IN THE MATTER OF THE INSOLVENCY ACT 1986

B E T W E E N:

HER MAJESTY'S REVENUE AND CUSTOMS

Appellant

- and -

(1) ANTHONY VICTOR LOMAS
(2) STEVEN ANTHONY PEARSON
(3) RUSSELL DOWNS
(4) JULIAN GUY PARR

(in their capacity as joint administrators of Lehman Brothers International (Europe) (in administration))

Respondents

RESPONDENTS' SKELETON ARGUMENT

Introduction

1. This skeleton argument is filed on behalf of the joint administrators (the "Joint Administrators") of Lehman Brothers International (Europe) (in administration) ("LBIE") in opposition to the appeal of Her Majesty's Revenue and Customs ("HMRC") against the declaration of Hildyard J (the "Judge") that:

   (1) statutory interest payable pursuant to rule 2.88(7) ("Rule 2.88(7)") of the Insolvency Rules 1986 is not yearly interest for the purposes of section 874(1) of the Income Tax Act 2007 ("Section 874(1)"); and

   (2) the payment of statutory interest pursuant to Rule 2.88(7) does not give rise to any obligation on the part of a company in administration or on the part of the company's administrators to deduct amounts representing income tax.

2. The Joint Administrators respectfully invite this Court to dismiss the appeal on the basis that the Judge's declaration was rightly made for the reasons given by him in his judgment. The Judge's reasoning is gratefully adopted in its entirety. This skeleton elaborates on parts of the Judge's reasoning in the hope that this may be of further assistance to the Court.

The parties' positions

3. On their appeal, HMRC contends that:

   (1) in order for interest to be "yearly interest" all that is required is that, when an unconditional entitlement to it first arises, the interest must be payable in respect of a year or more;

   (2) because, in this case, the period from the commencement of LBIE's administration to the payment of dividends to creditors in respect of their proved debts was longer than a year, statutory interest payable out of the surplus in LBIE's administration constitutes yearly interest.

4. The alternative argument advanced before the Judge and rejected by him (see at [37], [52], [53], [54], [76] and [77]) is not now pursued in HMRC's grounds of appeal and skeleton before this Court.

5. The Joint Administrators contended before the Judge, and maintain before the Court of Appeal, that statutory interest paid pursuant to Rule 2.88(7) is not yearly interest. The essence of their case can be distilled as follows:

   (1) To have yearly interest there must be an obligation to pay the same now or at some time in the future in respect of a period during which the same accrues. That period needs, at least, to be capable of being for a year or more.

   (2) It follows that a period of accruer is a necessary constituent of yearly interest.

   (3) Interest does not accrue during a period when there is no obligation to pay the same even though such an obligation might arise in the future. That follows in

relation to statutory interest from the judgment of David Richards J in **Waterfall IIA** at [149] and [154].[1]

(4) If – as in the present case – any entitlement to interest only arises on or after the repayment of the principal, then it cannot be yearly interest. There is no accruer or continuation of the interest; there is merely a one-off obligation calculated by reference to a past period. The interest here is not dependent on the existence of the debt claim; it arises only out of the subsequent ascertainment of the existence of a surplus.

(5) The period of calculation cannot be the discrimen. That was not the basis of decision in **Bebb v Bunny**[2] and the line of authority following that case. In **Gateshead Corporation v Lumsden**[3], for example, interest was paid for many years but still held not to be yearly interest. The argument advanced in **Lumsden** and rejected by the Court of Appeal is the same as HMRC's argument here. In any court below the Supreme Court, HMRC's case is required to be rejected by binding authority.

6. A more expanded summary of the Joint Administrators' submissions is stated by the Judge at [34].

Background

7. The issue in dispute is one of pure law but the essential background can briefly be summarised as follows:

8. LBIE is an English unlimited company, and was the principal trading company within the European group of Lehman Brothers companies. LBIE entered into administration on 15 September 2008.

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[1] **Lomas & Ors v Burlington Loan Management Ltd & Ors** [2015] EWHC 2269, [2016] Bus LR 17.

[2] (1854) 1 K & J 216

[3] [1914] 2 KB 883 - following the principle of the decision in **Bebb v Bunny** (1854) 1 K & J 216.

9. On 30 April 2014, the Joint Administrators paid a fourth and final dividend in respect of the proved claims of LBIE's unsecured creditors, which took the aggregate dividends paid to 100 pence in the pound.

10. The Joint Administrators estimate that, subject to a number of important assumptions, there will be a surplus of in the region of £6.9 billion to £8 billion after the payment in full of the proved claims of all general unsecured creditors.

11. Before being applied for any other purpose, the surplus is required to be applied in paying interest on the debts proved in LBIE's administration in respect of the periods during which they were outstanding since LBIE entered administration. The interest so payable is commonly referred to as "statutory interest".

Statutory interest

12. Rule 2.88 sets out the provisions for the payment of interest in an administration and (in the form which was in force on 15 September 2008 and which therefore applies in the administration of LBIE) relevantly provides as follows:

> *"(1) Where a debt proved in the administration bears interest, that interest is provable as part of the debt except in so far as it is payable in respect of any period after the company entered administration or, if the administration was immediately preceded by a winding up, any period after the date that the company went into liquidation.*
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> …
>
> *(7) [A]ny surplus remaining after payment of the debts proved shall, before being applied for any purpose, be applied in paying interest on those debts in respect of the periods during which they have been outstanding since the company entered administration.*[4]
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> *(8) All interest payable under paragraph (7) ranks equally whether or not the debts on which it is payable rank equally.*

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[4] Rule 2.88(7) previously began *"Subject to Rule 2.105(3),"*; these words were omitted by the Insolvency (Amendment) Rules 2005 in consequence of an amendment to Rule 2.105 of the Insolvency Rules 1986 to the formula for use in calculating the discounted value of a debt which is not due for payment at the date of dividend payment, following **Re Park Air Services Limited** [2000] 2 AC 172.

> (9) *The rate of interest payable under paragraph (7) is whichever is the greater of the rate specified under paragraph (6) [section 17 of the Judgements Act 1838] and the rate applicable to the debt apart from the administration."*

13. The nature of "statutory interest" (as it is commonly referred to) under Rule 2.88(7) was considered in detail by David Richards J in **Waterfall IIA** and the effect of his decision is correctly summarised by the Judge at [8], [9] and [10]. Although not repeated herein, those paragraphs are critical to an understanding of the nature of statutory interest and the determination of this case. The Judge also rightly rejected HMRC's argument on this point at [11] to [17], in particular, and following the judgment of David Richards J[5], in rejecting HMRC's argument that statutory interest here constituted a "contingent right". This argument is repeated in HMRC's skeleton to this Court in a number of places, in particular at [6] but it is the same argument as was rejected by David Richards J in **Waterfall IIA** at [154] and also rejected by the Judge at [10] to [17].

Deduction of tax

14. Chapter 3 of Part 15 of the Income Tax Act 2007 provides for the deduction of tax from certain payments of yearly interest. In particular, sections 874(1) and (2) provide as follows:

> "(1) *This section applies if a payment of yearly interest arising[6] in the United Kingdom is made—*
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> (a) *by a company,*
>
> (b) *by a local authority,*
>
> (c) *by or on behalf of a partnership of which a company is a member, or*
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> (d) *by any person to another person whose usual place of abode is outside the United Kingdom.*

[5] **Lomas & Ors v Burlington Loan Management Ltd & Ors** [2015] EWHC 2269, [2016] Bus LR 17.

[6] The statutory charge in respect of interest was found in Case III of Schedule D and Schedule D generally applied to *"annual profits or gains arising or accruing."* The words *"or accruing"* were omitted in consequence of the Tax Law Re-Write's modernisation of language.

> (2) *The person by or through whom the payment is made must, on making the payment, deduct from it a sum representing income tax on it at the basic rate in force for the tax year in which it is made."*

15. The statutory history is complicated; however, some appreciation of the development of deduction at source rules is necessary both in order to understand the nature of yearly interest and also in order to place in context the relevant judicial authorities. An outline history is therefore set out in the Appendix to this skeleton argument which, with minor expansions, is the same as that relied upon by the Joint Administrators before the Judge and (in the Appendix to the Judge's judgment) largely adopted by him.

16. The precise terms of the deduction rule currently found in Section 874 date back to 1969. Prior to then there were two mutually exclusive "deduction at source" provisions that could potentially apply to interest. First, a "permissive rule", which – like Section 874 ITA – applied to *yearly interest*, and which authorised the payer to make a deduction, if the payment was made wholly out of profits or gains charged to tax. This rule can be traced back to 1803 (see the Appendix at [3] to [5]). Secondly, there was a "mandatory rule" that required a deduction if interest *(of any kind)* was not wholly paid out of profits or gains charged to tax.

<u>The nature of yearly interest</u>

17. The notion of *"yearly interest"* has existed from the beginnings of income tax and the term appeared in Addington's Income Tax Act of 1803, referring to *"all Annuities, yearly Interest of Money, or other annual Payments"* (section 208). It is used interchangeably with the term *"annual interest"*.[7] At inception no other interest was charged and deduction of tax at source only applied to yearly (annual) interest. This plainly recognised that such interest arose only on debts of some ongoing permanence or significance on which interest payments were likely to arise from time to time, as opposed to "one off" situations, and to which a deduction of tax procedure was appropriate (see the Appendix to this skeleton argument at [5] to [9]).

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[7] See **<u>IRC v Frere</u>** [1965] AC 402, at 419F–G, per Lord Radcliffe; and, for example, the side-note of s102 of the Income Tax Act 1842, which refers to *"annual interest"*, whilst the section itself refers to "*yearly interest"* (likewise see section 349 of the Income and Corporation Taxes Act ("ICTA") 1988, and section 54 ICTA 1970, and the original provision in section 208 of the 1803 Act).

18. The first reported case containing any detailed consideration of the nature of yearly interest is **Bebb v Bunny** (1854) 1 K & J 216. The issue was whether the permissive rule (which was the only rule existing at the time) applied to interest payable to a vendor on unpaid purchase money. In deciding the matter, one difficulty (noted at 218-9) was reconciling the treatment of interest on mortgage loans as yearly interest (given that such loans were in legal form generally short loans for six months, whereas in substance they were understood to be long-term loans).[8]

19. Sir William Page Wood V-C explained, at 219–20, that:

> *"The whole difficulty is in the expression 'yearly' interest of money; but I think it susceptible of this view, that it is interest reserved, at a given rate per cent, per annum; or, at least, in the construction of this Act, I must hold that any interest which may be or become payable* ***de anno in annum****, though accruing* ***de die in diem****, is within the 40th section.*[9] *...*
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> *I consider the Act very singularly worded, yearly interest being used apparently in the same sense as annual payments; but I am clearly of opinion that it means at least all interest at a yearly rate, and which may have to be paid de anno in annum; such as interest on purchase-money, as well as mortgage interest; and that, therefore, the purchaser is entitled to deduct the tax in this case."*
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> (Underlining added.)

The first paragraph of the above passage contains the key to the qualities required for identifying yearly interest – something payable year by year (the quality of recurrence) and accruing day by day. It is definitional and (contrary to what is said at [8] of HMRC's skeleton argument) accrual is a necessary constituent of that definition. Without those qualities an item would not constitute yearly interest. That early statement of principle has never been doubted since.

20. **Bebb v Bunny** was considered in **Goslings and Sharpe v Blake** (1889) 23 QBD 324, where the question was whether or not interest received by a banker on certain loans for a specified time of less than a year was yearly interest. It was unanimously held that, in the case of such a loan, where there was no intention for the loan to remain

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[8] cf. **Goslings and Sharpe v Blake** (1889) 23 QBD 324, at 330–1, per Lindley and Bowen LJJ.

[9] Section 40 of the Income Tax Act 1853 (see the Appendix at [9]).

outstanding for a long period, the interest was not yearly interest (even if calculated by reference to a yearly rate).

21. The principle resulting from **Bebb v Bunny** and **Goslings and Sharpe v Blake** is that for interest to be yearly, it is necessary to consider the period over which it is envisaged that the interest will accrue: if this is less than a year, then it is indicative of its not being yearly interest, no matter how the interest rate is expressed.[10]

22. It follows from the above that it is a prerequisite that yearly interest must be capable of accruing and must accrue for some period and be payable from year to year (whilst it accrues). This is the key point to this case, establishing that statutory interest cannot be "yearly interest".

23. The importance of having a period over which yearly interest accrues is also evident from the basis that was used to determine the rate at which to make the deduction under the permissive rule. This issue as to what rate to use first arose with the 1853 Act, which imposed different tax rates for different years; it was resolved by specifying that the rate at the time the interest became due would be used. This was later changed, so that, from 1864 to 1927, the amount of tax to be deducted on the payment of yearly interest was determined by an average of the tax rates *"during the Period through which the [interest] was accruing due"* (see the Appendix at [10]). This clearly presupposed that there is a period over which yearly interest accrues, and that such a period of accruer might span two or more fiscal periods in which different tax rates are in force. It is implicit in this that accrual is a necessary constituent of yearly interest: it cannot simply be discarded as a reference to "the ordinary case" as suggested in HMRC's skeleton argument at [20(iii)]. This needs to be contrasted with non-yearly interest where deduction was made at the tax rate applicable on the date of payment. This recognised a critical distinction between yearly and other interest.

24. Subsequent authorities have not taken the position much further. In re Cooper [1911] 2 KB 550 concerned a few days' interest on a judgment debt; Cozens-Hardy MR concluded it was not yearly interest, saying, at 553-4:

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[10] See also **Re Craven's Mortgage** [1907] 2 Ch 448.

> *"Now in the present case I ask myself is it possible to suppose that this was a transaction in which anybody contemplated or intended anything permanent? It is quite impossible so to regard it. ... I fail to see what ground there can be for saying with regard to a transaction of this kind, where in truth there was not even an agreement for a short loan,—where there was merely a judgment debt, which it is true by law carries interest for this seven days in question—that that is a transaction to which the language of the Income Tax Acts about 'yearly interest' can fairly be applied."*

25. In **Gateshead Corporation v Lumsden** [1914] 2 KB 883, the local authority had a statutory right to allow the debtor to pay instalments with interest payable on the amounts outstanding from time to time. The local authority allowed payment in instalments of interest and principal over many years. Lord Sumner explained the facts, at page 888, and then went on to analyse why it is not yearly interest, at pages 889 to 890:

> *"All that we have is the fact that there was a debt presently due, incurred on account of the expenses, and, if the local authority had chosen to enforce it, presently payable, which debt the local authority under the powers of s. 32 of the local Act did not immediately enforce and have not enforced for a substantial period of time."*
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> ...
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> *I do not say that the present case is concluded by the decision in In re Cooper [1911] 2 KB 550, though I think it would be difficult to distinguish it; but applying the principle underlying that decision, I am unable to see how the words 'yearly interest' can apply to this transaction. There is no agreement for a short loan or a long loan. The debt is due and repayment is not enforced; only in that sense is there a loan. Truly speaking there is simply a forbearance to put in suit the remedy for a debt. The repayment might have been enforced at any moment. The debt might have been paid by the debtor at any moment. It carried interest by law, because under s. 32 of the local Act the local authority could and did attach a rate of interest to it. The fact that the rate of interest is calculable at an annual figure is, as was pointed out in Goslings v. Blake 23 QBD 324, immaterial. The debt here was well secured, and the creditor, unlike the creditor in In re Cooper, did not desire immediately to enforce payment of it. The plaintiffs were no doubt to receive interest on it, but not in such a form as would apply to it the words 'any yearly interest of money' in s. 40 of the Income Tax Act, 1853."*

26. It has also been held that the loan in respect of which interest is paid must be intended to have the quality of an investment. Rowlatt J said in **Garston Overseers v Carlisle** [1915] 3 KB 381, at 386, *"yearly interest means, substantially, interest irrespective of*

the precise time in which it is collected, interest on sums which are outstanding by way of investment as opposed to short loans or as opposed to moneys presently payable and held over or anything of that kind." This again reflects the rationale for the application of the deduction at source procedure.

27. The older authorities such as **Garston Overseers v Carlisle** and those to the like effect are in contrast to the position here. The general unsecured creditors in an administration would not normally be taken as intending to make loans to the company in consequence of its administration; indeed (i) entry into an insolvency process will often trigger the acceleration of, or enable the creditor to accelerate, debts which are not currently payable; and (ii) the moratorium in the administration is often the only thing preventing them seeking to enforce their claims to be repaid immediately.

28. This was also the criterion used by Lord Denning MR in **Corinthian Securities Ltd v Cato** [1970] 1 QB 377, at 382; albeit, as subsequently pointed out by Sir John Donaldson in **Cairns v MacDiarmid** [1983] STC 178, at 181j, the term "investment" is potentially treacherous as it is possible to have interest on very short term investments that is not yearly.

29. It has also been emphasised, in relation to contractual interest, that in determining whether it is envisaged that the interest will continue for at least a year, the matter will be determined by the intention of the parties: see **Cairns v MacDiarmid**, at 181h; also **Minsham Properties v Price** [1990] STC 718, at 728f, per Vinelott J.

30. The reason for considering the intention of the parties in contractual cases is to discern the quality and characteristics of the right to interest that have been created by the agreement between them. However, in the case of statutory interest, where the parties (LBIE, the Joint Administrators and the creditors) have not created the right (which was instead created by legislation), their intentions are not relevant in determining its nature. **Rather, it is the legislator's intention in creating the statutory right that is relevant; the matter is accordingly to be determined by reference to the characteristics of the right as discerned from the legislation (which characteristics are, in the context of statutory interest, clear from the wording of**

the rule and have accurately been described by David Richards J in Waterfall IIA).

31. The nature of yearly interest was also considered by Lord Johnston, in the First Division of the Court of Session, in **Scottish North American Trust, Limited v Farmer** (1910) 5 TC 693, at 698:

> *"But the natural inference is that a distinction is drawn, with intention, between interest which can be properly described as annual, though it may be paid at shorter terms, and interest which cannot be so described, but is casual or anything from day to day upwards, short of annual. I think that the distinction between the two classes of cases may be somewhat aptly described by the use of a term of the Scots Law. Where the interest is payable in respect of an obligation having '**a tract of future time**,' it may, in the sense of the Statute be understood as annual, and where not, not. See opinions of Esher, M.R., and Lindley and Bowen, LL.J. in Goslings & Sharpe v Blake, L.R., 23 Q.B.D., 324."* (Emphasis added.)

32. The observation that the interest must be payable in respect of an obligation having a "tract of future time" was approved in **Commissioners of Inland Revenue v Hay** (1924) 8 TC 636, at 646, per Lord Anderson.[11] An obligation of that sort suggests that the right to the interest will not be fulfilled at once, and will have some prolongation or continuance: **it must accrue over a period**.

The quality of recurrence

33. Additional light as to the nature of yearly interest can be gained from considering that of annual payments. From the very first it was clear that yearly interest constitutes a type of annual payment: see footnote 21 of the Appendix. Thus, as with any annual payment, yearly interest must have the quality of recurrence or at least of being capable of recurrence: see **Moss' Empires Ltd v IRC** [1937] AC 785, at 795, per

[11] One of Lord Anderson's other propositions that there cannot be yearly interest on a loan repayable on demand goes too far, as observed by Lord Denning in **Corinthian Securities Ltd v Cato** [1970] 1 QB 377, at 382.

Lord Maugham; and **Goslings and Sharpe v Blake**, per Lord Esher MR, at 327.[12] Statutory interest does not have that quality.[13]

Is the interest under Rule 2.88(7) yearly interest?

34. It is uncontroversial that statutory interest is "interest" generally and for tax purposes. This follows from Rule 2.88(7) itself: it mandates the paying of "interest". Thus, in particular, statutory interest would fall within the income tax charging provisions relating to interest arising found in section 18(3)(a) of the Income Tax Act 2007, and sections 369(1) and 370(1) of the Income Tax (Trading and Other Income) Act 2005.

35. However, as explained above, statutory interest does not accrue from day to day, and it is not payable from year to year. There is no period of accruer and the interest is not payable unless a surplus has been ascertained following payment of the debts proved in full. By not accruing over time, it does not have the quality of yearly interest to which deduction of tax at source applies. This is evident from the terms of Rule 2.88 and follows from the judgment of David Richards J in **Waterfall IIA** summarised at [8], [9] and [10] of the judgment of the Judge below.

36. In the present case the interest in question is a pure statutory entitlement created by Rule 2.88(7). The right to the interest only arises on the ascertainment of a surplus and on the basis that the principal has been repaid; it is a "static" right and it does not carry the connotations of a *"tract of future time"*. **There is therefore no period of time during which a right to interest under Rule 2.88(7) exists and the principal on which any such right to interest accrues remains outstanding. Furthermore, there is no quality or capability of recurrence.**

37. Consequently, for the above reasons, as a matter of law statutory interest cannot constitute yearly interest. There is no need to go on to consider over what period it

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[12] The quality of recurrence (or capability of it) is a necessary, but not sufficient, condition for something to be an annual payment: **Whitworth Park Coal v IRC** [1961] AC 31, at 66, per Lord Radcliffe.

[13] And interest other than yearly interest may well not have that quality: see Lord Radcliffe in **IRC v Frere** [1965] AC 402, at 427, where he considered that the interpretation of the mandatory rule as applying to non-yearly interest was *"singularly ill-judged"*.

would be envisaged that the interest would accrue, since no such period of accruer can or does exist.

38. The position of the Joint Administrators (and the Judge) has the significant advantage that the tax treatment of statutory interest will always be certain and be the same for any administration (or, in relation to the equivalent interest provision, any liquidation). It should not depend on how the particular administration is conducted, its complexity, the resources available, or the particular views or expectations of the administrators or the creditors, or require application to the Court. This follows from the structure of the right created in Rule 2.88(7) by Parliament and as correctly identified in **Waterfall IIA**.

The position of HMRC

39. On their appeal, HMRC contends that in order for interest to be "yearly interest" all that is required is that, when an unconditional entitlement to it first arises, the interest must be payable in respect of a year or more (HMRC's skeleton argument at [2]). In this case, HMRC argues, that period will have already passed. HMRC goes on to say, because the period from the commencement of the administration to the payment of the dividends to creditors in respect of their proved debts exceeded a year, the statutory interest payable out of the surplus constitutes yearly interest.[14]

40. HMRC's argument is inconsistent with the concept of yearly interest and more than 160 years of authority. Mere *quantification* by reference to a period of a year or more does not make a payment yearly or annual. The point can be illustrated by the example of a father who had intended to make a gift of £1,000 to his daughter on her 21st birthday, but did not get around to it for some years. He then subsequently gifts the money together with an amount which he computes by reference to a yearly "interest" rate on that sum. There is a period of the computation of an amount of "interest" but the additional payment is simply a fixed amount; there is no period over which it continues or accrues, the period having passed. It does not have the quality

[14] HMRC appears to have abandoned the alternative way in which the case was put at first instance and the Joint Administrators therefore do not engage with it in this skeleton argument.

of being annual or yearly, and such a method of computation does not even result in its becoming interest.

41. The mere length of a period by reference to which the interest ends up being computed does not determine whether it is yearly or annual; cf. **Gateshead Corporation v Lumsden** (where interest was paid over many years but held not to be "yearly"). Moreover, in the case of contractual interest, the courts have not taken the view that the matter is simply determined by the calculation period; the matter is determined by the intention of the parties. Clearly it would have been possible to apply a rule simply based on the calculation period to contractual interest, and it would have provided a fixed numerical criterion. However, the reason it was not so applied is that the calculation period does not determine the *quality* of the interest in question.

42. As the key cases referred to above demonstrate, whether or not something is yearly interest depends on its character and is generally determined by considering whether it accrues and, if so, the period over which it is envisaged that it will accrue; such a matter is therefore generally determinable at the outset when the payer needs to know whether to deduct tax or not, unless there is some definite change in circumstance. This is for good reason, since, in general, interest may be paid from time to time. There may be a succession of payments, with some made within a year of the liability beginning and some after. The interest does not suddenly alter its character, because in fact a period of a year has elapsed.

43. Moreover, in relation to the particular statutory interest under consideration: Rule 2.88(7) refers to "periods" in the plural in order to allow for the situation in which there is more than one distribution made in respect of the proved debts (see **Waterfall IIA**, at [135]). Consequently, it may be that in the same administration statutory interest will be calculated by reference both to periods greater than a year and to periods less than a year. It would be strange if this resulted in some part of the statutory interest being yearly (and subject to deduction under Section 874), and some part being non-yearly.

44. HMRC seeks to rely on three cases as supporting their approach. The same "*trilogy of cases*" were "*at the forefront of [HMRC's] submissions*" before the Judge (see [39]

and [72]) and are dealt with in his judgment at [65ff]. For the reasons given by the Judge, none of these cases, in fact, "*displays any solid basis for their contentions*".

45. First, HMRC relies on **Barlow v Commissioners of Inland Revenue** 21 TC 354. This was a case which the settlor, one of the trustees of certain settlements made by him in favour of his children, in 1923 acted in breach of trust by realising the trust investments and re-investing the proceeds in unauthorised securities in his own name and, to compensate the trust, he covenanted by deed in 1930 to pay a principal sum together with compound interest on such sum from 1923, the time of the breach, until the date of the deed. Finlay J held the interest to be yearly interest.

46. The case does not advance HMRC's argument because the entitlement to interest arose not in 1930 when the deed was executed but in 1923 when the breach of trust occurred. Where there is a breach of trust, there is, from that time, an obligation imposed by equity to make good the trust funds, and interest runs in the meantime[15]. Accordingly, in **Barlow**, from the date of the breach, the defaulting trustee was obliged, as a matter of equity, to account for the losses caused by his breach of trust together with interest thereon. All that occurred in 1930 was that the already existing liability of the defaulting trustee to account in respect of the losses, with interest, was recognised by the deed. The suggestion that the relevant interest arose "*under the deed and was distinct from any other obligation that existed prior to the deed being executed*" (HMRC's skeleton argument at [13]) is divorced from reality. Interest had accrued on the losses from the breach of trust in 1923 and the deed merely recognised that fact and put a value on the interest. The position is no different from a simple acceptance of that existing liability.

47. The Joint Administrators therefore agree with the Judge's treatment of the case at [66].

48. Secondly, HMRC relies upon **Regal Hastings v Gulliver** (1944) ATC 297. In that case, as the Judge summarised it at [39(2)]: "*…the directors, having profited from their fiduciary position, were required to account for the profit made and pay interest in respect of the period commencing when the profit accrued in 1935 to the time of payment in 1942. Cassels J considered the interest to be yearly interest.*"

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[15] **Vyse v Foster** (1872-73) L.R. 8 Ch. App. 309

49. **Regal Hastings v Gulliver** is, therefore, to the same effect as **Barlow** and takes HMRC no further. The directors were under an equitable liability to account for profits made by them in breach of their fiduciary duties to the company and to pay interest thereon from the date of their breach of fiduciary duty. The fact that the liability was reflected in an Order of the Court requiring interest to be paid is nothing to the point. It is wrong to characterise the obligation to pay interest as part of an equitable duty to make good the trust funds as being a contingent obligation because it is ultimately dependent upon the exercise of a discretion by the court (*cf*. HMRC's skeleton argument at [13(b)]). The Order did not create the liability, it recognised its existence, and the interest which the directors were obliged to pay as a matter of equity accrued from the moment in time when they breached their fiduciary duties to the company.

50. The Joint Administrators respectfully endorse the Judge's treatment of the case at [67] to [70].

51. The third case relied upon by HMRC, **Jefford v Gee** [1970] 2 QB 130, concerned the payment of interest in personal injury cases under the Law Reform (Miscellaneous Provisions) Act 1934. Contrary to what HMRC suggests, the position in relation to damages has never been clearly determined and has long been open to doubt; likewise judgment debts (cf. **In re Cooper** referred to above):

    (1) **Jefford v Gee** itself was a personal injury case; the tax position in relation to deduction was acknowledged, at 134G, to be *"very complicated"* and does not appear to have been the subject of detailed argument.

    (2) Lord Denning MR referred in passing (at 149C) to the interest being taxable because it was yearly interest relying on **Riches v Westminster Bank** [1947] AC 390. However, **Riches v Westminster Bank** concerned the mandatory rule that applied to *any kind of interest*; moreover, leaving aside the deduction rules, any kind of interest at that time would still have been chargeable to tax within Case III of Schedule D.

    (3) Furthermore, at 149D–E, Lord Denning wisely refused to become embroiled in this issue, saying: *"There are special statutory provisions about deducting tax.*

... Interest should be computed and awarded as a gross sum payable by the defendant, leaving him to work out whether he should deduct tax or not."

52. More fundamentally, however, Lord Denning was assimilating the position to **Riches v Westminster Bank**, which concerned interest on a *judgment debt*; unsurprisingly this was held to be interest for the purposes of the mandatory deduction rule that applied to all kinds of interest (and not just yearly interest). Further, as explained in **Waterfall IIA** by David Richards J, at [109]–[114] and [145], interest on judgment debts is of a different nature, and in particular, as he rightly observed, *"Interest on a judgment debt accrues due while it is outstanding just as much as interest under a contract"*. Thus such interest could be yearly interest but not so the statutory interest created by Rule 2.88.

53. The Joint Administrators agree with the Judge's treatment of **Jefford v Gee** at [71]. HMRC's skeleton argument at [13(c)ii] suggests that the Judge's reference to the award of interest being "mandatory" was incorrect, but it was not – as can be seen from Lord Denning's judgment in **Jefford v Gee** at 142E–H.

54. Accordingly, properly analysed, the three cases on which HMRC places reliance in supposed support of their appeal do not support the appeal at all.

55. Further, as the Joint Administrators submitted to the Judge, and as he accepted at [74] to [77], HMRC's argument is also fraught with practical difficulties and concerns:

    (1) First, if it were correct, Administrators might come under enormous pressure to admit proofs and pay dividends prior to the first anniversary of an administration.

    (2) Secondly, creditors' proofs are not dealt with all at the same time. It is quite possible that some creditors will receive payment of 100p in the £ prior to the first anniversary of an administration but others will not. There may be disputed debts which the administrator has provided for in full but which are not admitted prior to the first anniversary of the administration. Such a scenario begs the question whether the creditors whose debts were admitted and paid prior to the first anniversary of the administration are to receive statutory interest without deduction but those whose debts are only admitted after the first anniversary are

to have income tax deducted from the statutory interest paid to them. Such an outcome would be wholly unprincipled and without merit.

(3) That scenario might also result in creditors, in any case where there was the slightest prospect of substantial dividends and, possibly a surplus resulting, scrambling to have their proofs adjudicated upon, both by the administrator and, potentially, by the court, within the first 12 months of the administration. One can envisage applications being made by creditors to lift the statutory stay on proceedings with a view to establishing their claims through Part 7 proceedings if they consider that that would give them an advantage in receiving dividends prior to the end of the first year of the administration.[16]

(4) It would, in any event, be an odd and unsatisfactory result for deductions to be made from statutory interest: (i) payable to some creditors but not others in the same administration; and (ii) in some administrations but not in others.

56. HMRC's comments on these practical concerns (at [30] of their skeleton argument) do not deprive them of their force. The points go to determining the legislative purpose of the provisions. Whilst the practical concerns do not have any bearing on the true meaning of yearly interest, they strongly suggest that the draftsman did not intend, or would not have intended, to create a form of interest which is yearly interest giving rise to any obligation to deduct income tax.

57. The fact that the practical concerns do not arise in the context of this administration is no answer to the existence of the concerns. They are capable of arising in other administrations and whether or not statutory interest is capable of being yearly interest must be tested with reference to the legislative intention viewed in light of the problems such a result would create. It may be rare for a surplus to arise in an administration, giving rise to the obligation to pay statutory interest, but (as here) surpluses do arise and the frequency with which they do or do not arise is irrelevant to the determination of the issues raised by HMRC's appeal. The Joint Administrators do not suggest that the meaning of yearly interest should be distorted to deal with the

[16] The same points arise equally in relation to statutory interest payable out of a surplus arising in a liquidation, pursuant to section 189(2) of the Insolvency Act 1986.

practical concerns that HMRC's analysis would lead to. They do suggest that HMRC's analysis is flawed and that the existence of the practical difficulties which flow from HMRC's analysis help to demonstrate that the draftsman cannot have intended to create yearly interest when drafting Rule 2.88(7).

58. There is, in any event, no suggestion in Rule 2.88(7) that the legislative intention is for the statutory interest to be *yearly interest*; indeed, as the detailed analysis of David Richards J demonstrates, the legislative intention is all to the contrary, since the interest does not accrue. The legislation has manifestly created a right which does not have the quality of yearly interest (and, in consequence of its not being yearly in nature, it is therefore not subject to any deduction obligation).

Conclusion

59. Statutory interest paid pursuant to Rule 2.88(7) does not accrue from time to time over any period and it cannot be *yearly interest* within the meaning of Section 874 ITA 2007. There is, as a result, no obligation or entitlement to deduct at source. The Joint Administrators accordingly ask the Court to dismiss HMRC's appeal, with costs.

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APPENDIX

History of the deduction of tax from yearly interest — a brief summary[1]

1. Pitt's Income Tax Act of 1799 charged *"Income from Offices, Pensions, Stipends, Annuities, Interest of Money, Rent Charge, or other Payments of the like Nature, being of certain Annual Amount"* under Case 16 of the Schedule.[2] The rules for general deductions from income allowed the deduction of, *"The Amount of Annual Interest payable for Debts owing by the Party, or charged upon the Property of the Party, from which any Income shall arise."*

2. Pitt's Act was not a success and the yield was poor, and it was repealed in 1802, following the Peace of Amiens.

3. Addington's Income Tax Act of 1803[3] was introduced following the resumption of hostilities in the French Revolutionary and Napoleonic Wars. It introduced the principle of deduction of tax at source, as well as the Schedular system that underpinned income tax for two hundred years. Interest of money was not one of the Scheduled sources of income[4]; however, *"Annuities, yearly Interest of Money, or other annual Payments ... whether the same shall be received and payable half-yearly, or at any shorter or more distant Periods"* were expressly charged by s 208 of the 1803 Act.[5]

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[1] The various reliefs and exclusions from the deduction rules that have existed from time to time are not traced here. All underlining has been added for emphasis.

[2] (1799) 39 Geo 3 c 13, with the Schedule retrospectively substituted by 39 Geo 3 c 22. The superseded Schedule did not include the words "*being of certain Annual Amount"*. Case 9 of Pitt's Triple Assessment, enacted as (1798) 38 Geo 3 c 16, was similar.

[3] (1803) 43 Geo 3 c 122.

[4] It is likely that Addington was influenced in this regard by Adam Smith's *Wealth of Nations*, Book V, Part II, in which it was doubted that interest of money was a proper subject for direct taxation because of the intrusive *"inquisition into every man's private circumstances"* that would be required, and the risk of capital flight.

[5] It is also clear from the wording of the provision—which goes on to refer to "such annual Payment"—that yearly interest is regarded as a type of annual payment.

4. The 1803 Act also provided that in computing profits and gains under Case I of Schedule D, *"no Deduction shall be made on account of any annual Interest, or any Annuity, Allowance or Stipend, payable out of such Profits or Gains, except the Interest of Debts due to Foreigners not resident in* Great Britain*"*. However, where yearly interest was paid out of profits or gains charged to tax, section 208 authorised the payer to deduct an amount equal to the tax chargeable on the interest. The payer would then be able to retain this, and the tax on the yearly interest would be treated as discharged. This deduction at source mechanism was efficient since the Exchequer would effectively get its tax by denying the payer the right to deduct yearly interest paid out of taxed income in computing its profits or gains; it was left up to the payer to recoup this by making and retaining a deduction from the interest payment.

5. Thus at inception the deduction of tax at source in respect of interest only applied to yearly interest. It must have been the rationale that such deduction procedures were only intended for on-going, continuing situations of some permanence and significance (such as yearly interest and other annual payments). Note the reference to "*payable half-yearly or at any shorter or more distant periods*" and the fact that it is regarded as an annual payment. Non-yearly interest was not generally charged to tax.

6. The Income Tax Act of 1805[6] substituted a new Schedule D of which Case III charged *"Profits of an uncertain annual Value"*, the second item of which was *"The Profits on all exchequer bills, and other securities bearing interest payable out of the publick revenue, and on all discounts, and on all interest of money not being annual Interest, payable or paid by any persons whatever, shall be charged according to the preceding rule in this case."* Under the 1805 Act, all interest was clearly chargeable, but there continued to be a distinction between yearly interest that was charged by section 192 of the 1805 Act – which, if paid out of profits or gains, was deductible at source – and non-yearly

[6] (1805) 45 Geo 3 c 49.

interest to which no deduction of tax at source applied. The deduction provision therefore, at inception, was only intended to apply to recurring (yearly) interest.[7]

7. The legislation was consolidated in the Income Tax Act of 1806 (see section 114 and Schedule D in that Act).[8]

8. Income tax was abolished in 1816, but reintroduced by Sir Robert Peel in 1842. Following the scheme of the 1803-6 Acts, section 102 of the Income Tax Act 1842 charged *"Annuities, yearly Interest of Money, or other annual Payments"*, and provided for deduction at source where paid out of taxed profits or gains. Non-yearly interest was again only chargeable directly under Case III of Schedule D.

9. Gladstone's Income Tax Act 1853 supplemented the 1842 Act, and deduction at source in relation to yearly interest was continued in Gladstone's Income Tax Act 1853, section 40, and where there was deduction at source this was to be determined by the rate at the time the interest became due. The 1853 Act also brought *"all Interest of Money, Annuities, and other annual Profits and Gains"* directly within the express charging provisions of Schedule D.

10. Subsequently – where deduction at source applied – the determination of the rate was altered by section 15 of the Revenue (No. 1) Act 1864, which specified, *"That the Persons liable to and making any such Payment as aforesaid shall be entitled and are hereby authorized to deduct and retain thereout the Amount of the Rate or a proportionate Amount of the several Rates of Income Tax which were chargeable by Law upon or in respect of such Rent, Interest, Annuity, or other annual Payment, or the Source thereof, during the Period through which the same was accruing due, anything in the said recited Act to the contrary notwithstanding."* Thus, as a result, the tax rate was to be determined by reference to averaging the tax rates over the period of accruer, rather than

[7] i.e., as stated by section 192, *"where any payment shall be made from profits or gains not charged by this act, or where any interest of money shall not be reserved, or charged or payable for the period of one year"* the tax was charged directly; otherwise deduction at source was used (emphasis added).

[8] (1806) 46 Geo 3 c 65.

simply taking the tax rate at the time the interest became due. The provision presupposes that yearly interest must accrue over a period.

11. The position essentially continued until it was altered by section 24(3) of the Customs and Inland Revenue Act 1888, which made it compulsory to deduct tax at source where interest (of any kind) was not wholly paid out of taxed income. The amount to be deducted was based on the tax rate at the time of payment.

12. However, in the case of *yearly interest* that was wholly paid out of taxed income, the payer continued to be entitled (but not compelled) to deduct and retain an amount equal to the tax (in recognition of the fact that yearly interest was not deductible in computing taxable profits or gains); this continued to be based on the tax rates over the period of accruer until 1927. Thus for 63 years the rate of the tax deduction for yearly interest was based on those prevailing over the period of accruer and consequently presupposing that such a period must be a constituent of yearly interest.[9]

13. The legislation was consolidated in the Income Tax Act 1918, which preserved this dichotomy.[10] Rule 21 of the General Rules Applicable to all Schedules of the Income Tax Act 1918 provided for the mandatory deduction of tax at source where interest (of any kind) was not wholly paid out of taxed income (and for the rendering of an account and payment to the Revenue); whereas rule 19 permitted the deduction (and retention) of tax at source where yearly interest was paid out of wholly taxed income.

14. The position was preserved in the Income Tax Act 1952: section 169 (concerning yearly interest and other annual payments paid out of profits or gains wholly charged to tax) corresponds to rule 19 of the General Rules in the

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[9] Section 39 of the Finance Act 1927 changed this back to the rate at the time the amount payable became due. However, this was obviously still different in general from the rate at the date of payment, which continued to be used for the mandatory deduction rule that applied to interest (of any kind) not wholly paid out of profits or gains charged to tax.

[10] However, whilst section 24(3) of the 1888 Act referred to *"any interest of money or annuities"*; rule 21 in the 1918 Act referred to *"interest of money, annuity, or other annual payment"*.

1918 Act; and section 170 (concerning interest of any kind that was not paid out of wholly taxed income) corresponds to the former rule 21.

15. The Finance Act 1965 created Corporation tax. Section 48(5) disapplied the permissive rule in section 169 of the 1952 Act, in the case of payments made by UK companies, by treating the payments as *not* made out of profits or gains charged to income tax. Consequently, the mandatory deduction rule in section 170 of the 1952 Act would then apply. Section 52 also introduced the concept of *"charges on income"*, which included payments of yearly interest (and other annual payments); these were allowable as deductions against total profits.

16. The present deduction regime results from the changes made by the Finance Act 1969. Section 18(1) excluded yearly interest from the annual payments in relation to which s 169 of the 1952 Act permitted deduction at source (and, correspondingly, s 18(4) removed the prohibition on deducting annual interest in computing profits or gains). Section 26(3) FA 1969 excluded interest (of any kind) from the payments in relation to which s 170 required deduction at source; whilst s 26(1) (and (4)) FA 1969 created an obligation to deduct at source (and account to the Revenue) in the case of *yearly interest* paid by companies (as well as certain other categories of payers), or paid by any person to someone whose usual place of abode is outside the UK.[11]

17. Section 26 FA 1969 (the obligation to deduct at source where yearly interest was paid) was re-enacted as s 54 of the Income and Corporation Taxes Act 1970, and then as s 349(2) and (3) ICTA 1988. This became s 874 ITA 2007 and, as part of the Tax Law Re-Write's modernisation of language, the words *"of money"* were dropped, and the simple word *"arising"* used throughout instead of the former general Schedule D charging provisions *"arising or accruing"*.

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[11] Thus, whereas mandatory deduction had previously been capable of applying to all kinds of interest – as had been confirmed in **Lord Advocate v City of Edinburgh** (1903) 4 TC 627 – the new obligation was limited to yearly interest only; cf. the criticisms made of the **Edinburgh** decision by Lord Radcliffe in **IRC v Frere** [1965] AC 402, at 427.

A2/2016/4109

IN THE COURT OF APPEAL
(CIVIL DIVISION)

ON APPEAL FROM THE HIGH COURT OF JUSTICE CHANCERY DIVISION COMPANIES COURT (HILDYARD J)

IN THE MATTER OF LEHMAN BROTHERS INTERNATIONAL (EUROPE) (IN ADMINISTRATION)

AND IN THE MATTER OF THE INSOLVENCY ACT 1986

B E T W E E N:

HER MAJESTY'S REVENUE AND CUSTOMS
Appellant

-and-

(1) ANTHONY VICTOR LOMAS
(2) STEVEN ANTHONY PEARSON
(3) RUSSELL DOWNS
(4) JULIAN GUY PARR
Respondents

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