Neutral Citation Number: [2016] EWHC 2492 (Ch)

Case No: 7942 of 2008

IN THE HIGH COURT OF JUSTICE
CHANCERY DIVISION
COMPANIES COURT

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

AND IN THE MATTER OF THE INSOLVENCY ACT 1986

Royal Courts of Justice
Strand, London, WC2A 2LL

Date: 11 October 2016

Before :

THE HONOURABLE MR JUSTICE HILDYARD

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Between :

(1) ANTHONY VICTOR LOMAS
(2) STEVEN ANTHONY PEARSON
(3) PAUL DAVID COPLEY
(4) RUSSELL DOWNS
(5) JULIAN GUY PARR — **Applicants**

- and -

HER MAJESTY'S REVENUE AND CUSTOMS — **Respondent**

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John Gardiner QC, Daniel Bayfield QC and Philip Walford (instructed by **Linklaters LLP**) for the **Applicants**
David Goy QC and Catherine Addy (instructed by **General Counsel and Solicitor to HMRC**) for the **Respondent**

Hearing dates: 28 & 29 April 2016

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Approved Judgment

I direct that pursuant to CPR PD 39A para 6.1 no official shorthand note shall be taken of this Judgment and that copies of this version as handed down may be treated as authentic.

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THE HONOURABLE MR JUSTICE HILDYARD

Mr Justice Hildyard :

1. Lehman Brothers International (Europe) ("LBIE") has been in administration since 15 September 2008. There is a substantial surplus in the administration (presently estimated to be between £6.6bn and £7.8bn) which is to be used, amongst other things, to pay statutory interest to creditors under the provisions of paragraph (7) of Rule 2.88 of the Insolvency Rules 1986 ("Rule 2.88"). This unusual situation has given rise to a variety of novel legal issues on which LBIE's Joint Administrators ("the Joint Administrators")[1] have sought the directions of the Court, principally in the various *Waterfall* applications. The question arising in this present application (issued on 22 December 2015) is whether such statutory interest, when paid, will rank as 'yearly interest' for the purposes of section 874 Income Tax Act 2007 ("Section 874"). If it does, the Joint Administrators will be required, subject to specific statutory exceptions, to deduct basic rate income tax from the payments made and account for the same to the Respondents. If the interest is not '*yearly interest*', no such obligation will exist and payments will be made gross.

2. In summary as to the respective arguments, the Joint Administrators submit that the statutory interest to be paid under Rule 2.88(7) does not accrue from time to time over any period and is not '*yearly interest*' within the meaning of Section 874: therefore there can be no obligation to deduct tax. Initially, Her Majesty's Commissioners for Revenue and Customs ("HMRC") agreed, and gave a number of confirmations to that effect. However, on reviewing the issue and its fiscal impact, HMRC have altered their position and now contend that the statutory interest is '*yearly interest*' within the meaning of Section 874 and as such a distribution of statutory interest should be subject to deduction of income tax at source. In HMRC's submission this conclusion follows on the basis that the statutory interest payable is calculated and payable in respect of periods in excess of a year, commencing at the time of the commencement of the administration. I return to elaborate on these arguments later.

3. Given the size of the surplus, and the rate of interest payable (see below), the sums involved are considerable. The Joint Administrators estimate the value of statutory interest calculated from the date of administration to the date of the final dividend to be in the region of £5bn.

4. Furthermore, the significance of the issue (particularly to HMRC, who have stated that the "risk to the Exchequer potentially runs up to £1.2bn") in monetary and fiscal terms is the greater because many of the creditors entitled to interest are non-resident, and under existing legislation non-residents cannot be charged to tax in relation to UK source interest beyond any amount deducted at source: if there is no deduction at source, then no tax is due (and see sections 811 and 815 of the Income Tax Act 2007).

5. Of course, and as the applicant Joint Administrators were at pains to emphasise, the amounts involved and the residence of the recipients are irrelevant to the determination of the legal question raised by the application. However, the significance of both aspects in revenue terms reinforces the appropriateness of

[1] It should be recorded that the Third Applicant, Paul David Copley, was one of the Joint Administrators when the application was issued, but resigned as such on 24 June 2016. References to "Joint Administrators" should be construed accordingly.

seeking the Court's directions, and may also explain HMRC's departure from their initial statements, including published statements[2], to the effect that no deduction at source was required.

Nature and rate of statutory interest

6. Rule 2.88(7), in the form in which it applies to LBIE[3], provides that,

> "Any 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."

7. The rate of interest which is payable under Rule 2.88(7) is, as prescribed by Rule 2.88(6) and (9), whichever is the greater of (i) the rate specified in section 17 of the Judgments Act 1838 on the date when the company entered administration or (ii) the rate applicable to the debt apart from the administration. (As at the date LBIE entered administration, and now, section 17 of the Judgments Act 1838 prescribes a rate of interest of "*8 pounds per centum per annum*".)

8. The nature of statutory interest under Rule 2.88(7) was considered in detail by David Richards J (as he then was) in the *Waterfall IIA* application.[4] In particular, "Issue 2" (considered at [30]–[154]) was concerned with how the dividends paid in the administration should be allocated between principal and statutory interest. In dispute was whether what was referred to as "the rule in *Bower v Marris*" could apply to statutory interest under Rule 2.88(7), so that a creditor would be free to treat the dividends received as appropriated to such interest, rather than principal (so that principal should remain outstanding for longer, thereby increasing the amount of interest).

9. David Richards J, agreeing with the Joint Administrators, held that the dividends could not be appropriated to interest. A key part of his reasoning is based on the nature and some of the characteristics of statutory interest. According to his analysis:

   (1) Rule 2.88(7) is a direction to the administration as to how any surplus "*remaining after payment of the debts proved"* is to be applied and is to be operated on the assumption that the debts proved have been paid. (See paragraph [134])

   (2) Interest is not payable in respect of any period after the relevant distribution has been made. (See paragraph [135])

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[2] See, for example, HMRC Guidance Statement INS7433 – Dividends: Insolvency (statutory) interest (though that has been withdrawn now). See also paragraphs 80 *et seq* below

[3] Rule 2.88 was amended by the provisions of SI 2010/686, subject to transitional provisions which provided that such amendments only apply where the relevant company entered administration on or after 6 April 2010.

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

(3) The principle in *Bower v Marris* is derived from the legal rules as to appropriation of payments towards debts. Those rules apply where there are two (or more) outstanding debts (relevantly one being as to principal and one being as to interest) payable by the debtor to the creditor. (See paragraph [144])

(4) The right to be paid statutory interest out of a surplus under Rule 2.88 is not a right to the payment of interest accruing due from time to time during the period between the commencement of the administration and the payment of the dividend or dividends on the proved debts. (See paragraph [149])

(5) The dividends cannot be appropriated between the proved debts and interest accruing due under Rule 2.88, because at the date of the dividends no interest was payable. [*ibid.*]

(6) The entitlement under Rule 2.88 to interest is a purely statutory entitlement, arising once there is a surplus after payment of the debts proved and payable only out of that surplus. [*ibid.*]

(7) The position is very different in relation to interest on contractual debts, judgment debts, or analogous types of interest (e.g. interest on debts in the administration of a deceased's estate), where the interest "*accrues due whilst it [i.e. the debt] is outstanding*". See paragraphs [109] to [114] and [145].

10. Paragraph [149] of David Richards J's judgment reads as follows:

> "The right to interest out of a surplus under rule 2.88 is not a right to the payment of interest accruing due from time to time during the period between the commencement of the administration and the payment of the dividend or dividends on the proved debts. The dividends cannot be appropriated between the proved debts and interest accruing due under rule 2.88, because at the date of the dividends no interest was payable at that time pursuant to rule 2.88. The entitlement under rule 2.88 to interest is a purely statutory entitlement, arising once there is a surplus and payable only out of that surplus. The entitlement under rule 2.88 does not involve any remission to contractual or other rights existing apart from the administration. It is a fundamental feature of rule 2.88, and a primary recommendation of the Cork Committee that all creditors should be entitled to receive interest out of surplus in respect of the periods before payment of dividends on their proved debts, irrespective of whether, apart from the insolvency process, those debts would carry interest."

11. As to the effect of that analysis, there is a disagreement between the parties, especially as regards the opening statement that statutory interest is not a right to the payment of interest "accruing due from time to time…"

12. HMRC contend that in so stating, David Richards J "can only mean that the right to any *payment* of such interest is contingent upon a surplus remaining after payment of

the proved debts and the extent of that surplus; and that but for such contingency the right to interest would 'accrue due' over time".

13. The Joint Administrators, on the other hand, contend that David Richards J's wording is clear, means what it says and constitutes a statement as to the nature of the right to interest out of a surplus under Rule 2.88 to the effect that the right is not one which accrues due over time.

14. The issue is obviously an important one. In my judgment, the Joint Administrators' contention is correct. I do not see any basis for the gloss or limitation proposed by HMRC. Further, in my view, HMRC's argument is contradicted by, or at the least inconsistent with, paragraph [154] of David Richards J's judgment in the same case, in which he addressed a very similar argument to that resurrected by HMRC now. He recorded and rejected the argument in the following terms:

> "Mr Dicker submitted that…[t]he statutory right to interest arising under rule 2.88 can be regarded, with hindsight, as having accrued on a day to day basis since the commencement of the insolvency process, albeit contingently on there being ultimately a surplus. Once the event occurs, the right to interest is treated as having accrued during the relevant period. I do not accept this submission…"

15. David Richards J's judgment is not binding on me; and it is subject to a pending appeal. However, unless convinced that it was wrong I should not depart from it; and I should confirm my own agreement with it on this point.

16. In my judgment, the statutory right to interest is *sui generis* and is not to be equated with a right to interest which accrues over time. Accrual signifies that a sum certain is being added over time, so that at any given time the amount accrued may be ascertained. The exercise in reverse engineering posited by HMRC in seeking to characterise as "accruing" a sum which, it is common ground, does not in fact become payable unless and until a right arises "at the end of the day" is not justified.

17. I do not accept either HMRC's submission that, even though there is no accrual *de die in diem* (or, as Mr David Goy QC (leading counsel for HMRC) put it in oral argument, "…you cannot say on a day-to-day basis that you will have an entitlement. So in that sense, you can't say it accrues…"), there is what Mr Goy chose to call a "conditional accrual". In truth, in my judgment, there is no accrual at all: the statutory right to interest arises only if and when a surplus is established.

The nature of 'yearly interest'

18. Having identified the character of the statutory right to interest, the question to which I now turn is the meaning of the phrase *'yearly interest'* in Section 874.

19. Section 874(1) and (2) provide as follows:

> "(1) This section applies if a payment of yearly interest arising[5] in the United Kingdom is made—
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> (a) by a company,
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> (b) by a local authority,
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> (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.
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> (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."

20. I should note at the outset that it is not disputed in the present case that the statutory interest in question is "interest" for the purposes of tax legislation. It is common ground, and I accept, that such treatment follows from the decision of the House of Lords in *Westminster Bank Ltd v Riches* [1947] AC 390 in which a sum of money awarded by the Court under the powers conferred by s.3(1) of the Law Reform (Miscellaneous Provisions) Act 1934 was held to be interest. Lord Wright said at p400:

> "[T]he essence of interest is that it is a payment which becomes due because the creditor has not had his money at the due date. It may be regarded either as representing the profit he might have made if he had had the use of the money, or conversely the loss he suffered because he had not that use. The general idea is that he is entitled to compensation for the deprivation. From that point of view it would seem immaterial whether the money was due to him under a contract express or implied or a statute or whether the money was due for any other reason in law."

21. The question in this case, therefore, is whether, and if so what, additional criteria must be satisfied for interest to qualify as *'yearly interest'*.

22. The concept of *'yearly interest'* is not defined in the relevant tax legislation; nor has it ever been so in its long and complicated statutory history. The precise term of the requirement for deduction at source currently found in Section 874 dates back to 1969; but it 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"* (*ibid.* at section 208). It is used interchangeably

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[5] 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.

with the term *'annual interest'*.[6] At inception, deduction of tax at source only applied to yearly (annual) interest.[7]

23. The nature of *'yearly interest'* has been explored and illuminated in numerous cases, but remains, in certain respects, elusive. To assist in understanding the complex historical context against which these cases were decided, I attach an Appendix summarising that history.[8]

24. In the case law, the first reported decision and starting point is *Bebb v Bunny* (1854) 1 K & J 216. In that case 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, so that a purchaser liable to pay interest on his purchase money would be entitled to deduct income tax from such interest. In deciding the matter, one difficulty (noted at pages 218 to 219) 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).[9] Sir William Page Wood V-C explained, at pages 219 to 220, 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.[10] …
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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."

25. *Bebb v Bunny* was considered (and distinguished) 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

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[6] See *IRC v Frere* [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 s 349 of the Income and Corporation Taxes Act ("ICTA") 1988, and s 54 ICTA 1970, and the original provision in s 208 of the 1803 Act).

[7] Prior to 1969 there were two mutually exclusive deduction at source provisions that could potentially apply to interest. First, a "permissive rule", which - like s 874 ITA 2007 - 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. It is this rule that can be traced back to 1803. Secondly, there was a "mandatory rule" which required that a deduction if interest *(of any kind)* was not wholly paid out of profits or gains charged to tax.

[8] This summary is derived from an Appendix attached to the Joint Administrators' skeleton argument; but I have made minor amendments and deletions to take out controversial aspects or matters of argument.

[9] cf. *Goslings and Sharpe v Blake* (1889) 23 QBD 324, at pages 330 to 331, per Lindley and Bowen LJJ.

[10] Section 40 of the Income Tax Act 1853.

was unanimously held in the Court of Appeal that, in the case of such a loan, where there was no intention for the loan to remain outstanding for a long period, the interest was not yearly interest (even if calculated by reference to a yearly rate). Bowen LJ said this (at page 331):

> "We are dealing in this case with short loans only, that is to say, with loans made for a period short of one year, loans which are not intended to be continued, and are not continued, for a long period. The question is whether the interest in such a case, where the interest has to be paid at the expiration of the short period, is yearly interest of money within section 40. It seems to me it is not yearly interest at all; it is not calculated with reference to a year in any sense, although it is true that it is expressed in a notation which is borrowed from the language of cases where there are yearly loans, or where the interest is calculated by the year. It is convenient to express in that notation the amount of interest that has to be paid, but it is not calculated on a year, nor on the supposition that the loans would last for a year, therefore it is not yearly interest. When it runs over, then the interest becomes payable during the times it runs over it, and is calculable with reference to the time it is outstanding, and the case may there be different. If this view is right we are not overruling what was said in *Bebb v Bunny.* The Vice-Chancellor there expressly confines his judgment to interest at a yearly rate which may have to be paid de anno in annum, such as interest on purchase-money or mortgage interest…"

26. These two cases were the bedrock of both parties' submissions; but they respectively drew very different conclusions from them, and built on these differences by reference to a variety of cases thereafter. I turn to elaborate on these different approaches.

27. The Joint Administrators, for whom Mr John Gardiner QC appeared (leading Mr Daniel Bayfield QC and Mr Philip Walford), submitted that the principle resulting from those two cases is that for interest to be *'yearly interest'*, 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 that is indicative of its not being yearly interest, no matter how the interest is expressed.[11] They submitted that it follows from this that it is a pre-requisite of *'yearly interest'* that it must be capable of accruing, and must accrue for some period, and be payable from year to year whilst it accrues.

28. To these criteria they added another: that *'yearly interest'* must have the quality of recurrence, or at least of being capable of recurrence. They relied in this respect on Lord Esher MR's judgment in *Goslings & Sharpe v Blake* (at page 327), and cited in further support Lord Maugham's speech in *Moss' Empires, Ltd v IRC* [1937] AC 785 at 795 and in particular the following passage:

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[11] Reference was also made to *Re Craven's Mortgage* [1907] 2 Ch 448.

> "…'annual' must be taken to have, like interest on money or an annuity, the quality of being recurrent or being capable of recurrence."

29. Mr Gardiner advanced also a more practical rationale for the requirement of having a period over which yearly interest accrues: the need to establish the basis for determining the rate at which to make the deduction under the permissive rule. He explained that 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 was determined by an average of the tax rates *"during the Period through which the [interest] was accruing due"*. Mr Gardiner submitted that this clearly presupposed that there is a period over which yearly interest accrues, and that such a period of accrual might span two or more fiscal periods in which different tax rates are in force. This, he reasoned, needs to be contrasted with non-yearly interest, where deduction was made at the tax rate applicable on the date of payment.

30. Mr Gardiner further submitted on behalf of the Joint Administrators that a further requisite quality of *'yearly interest'* is that the sums on which interest is payable for the relevant period must attract or accrue such interest by reference to some accommodation under which the payer and the payee have agreed to leave payment outstanding. There must be something akin to a loan which generates interest and which is intended to continue for at least a year. Forbearance to collect a debt immediately due and payable will not suffice, even if interest is payable during the period of forbearance. Mr Gardiner likened the moratorium in an administration to forbearance.

31. For the general proposition that there must be some element of shared intention and agreement to leave money outstanding by way of loan Mr Gardiner relied especially on *Gateshead Corporation v Lumsden* [1914] 2 KB 883. In that case, 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 and 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."

32. Mr Gardiner referred me also to *Cairns v MacDiarmid (Inspector of Taxes)* [1983] STC 178 in support of the submission that whether interest is properly describable as *'yearly interest'* depends on whether it was the true and shared intention of the parties that sums should be left outstanding for a period of a year or more and accrue interest which could properly be described as 'annual' (see *per* Kerr LJ at pages 182 to 183).

33. He also drew my attention to the decision of the Scottish Court of Session in *Scottish North American Trust, Limited v Farmer* (1910) 5 TC 693 at 698 where Lord Johnston said this:

> "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." (underlining added)

34. Drawing these criteria together whereby to test whether the right to statutory interest which arises in an administration if and when a surplus is established, Mr Gardiner submitted that:

    (1) Since statutory interest does not accrue from day to day and is not payable from year to year, so that there is no period of accrual and no interest is payable unless and until a surplus has been ascertained following payment of the debts proved in full, it does not have the quality of *'yearly interest'*.

    (2) The interest payable is a purely statutory entitlement created by Rule 2.88(7) as to the way in which a surplus is to be distributed; it is not based on any shared

intention or accommodation between the parties and there is no underlying transaction akin to a loan or investment such as in the other cases in which the quality of *'yearly interest'* has been held to have been satisfied. A statutory scheme of distribution is not an accommodation for the payment of *'yearly interest'*.

(3) The right to interest under the statutory scheme is not referable to an obligation having a *'tract of future time'*. The right to interest only arises on the ascertainment of a surplus and on the basis that the principal has been repaid: there is no period of time during which a right to interest under Rule 2.88(7) exists and the principal is outstanding on which any such right to interest accrues.

(4) Furthermore, there is no quality or capability of recurrence.

(5) In such circumstances, the statutory right to interest cannot constitute *'yearly interest'*.

(6) That conclusion means that there is no need to go on to consider over what period in any given insolvency process the interest would accrue, since no such period of accrual can or does exist. This has the significant advantage (*cf* HMRC's alternative argument, summarised in paragraphs [35] *et seq.* below) 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*.

35. Against this, Mr David Goy QC (leading Ms Catherine Addy) on behalf of HMRC submitted that there was no warrant in the case law or in the statutory wording for importing the criteria relied on by the Joint Administrators.

36. HMRC's primary case is that all that needs to be asked in determining whether the statutory right to interest satisfies the test of *'yearly interest'* is whether the amount of interest ultimately required to be distributed to a creditor out of surplus is, when distributed, calculated by reference to a period of a year or more.

37. HMRC's alternative argument is that the matter should be determined by looking at the position at the time the administration was commenced and whether the debts were likely to be repaid within a year: if not, then the interest payable will satisfy the criteria for qualification as *'yearly interest'*. Mr Goy drew a different conclusion from the cases referred to above. In particular, he submitted as to *Bebb v Bunny* and *Gosling & Sharpe v Blake*, that (I quote from his skeleton argument) the "upshot of the decisions…is that interest is yearly interest if it is payable in respect of a debt that will or may exist for a year or more. In such cases the interest can be said to be

calculated and payable by reference to a period of a year or more". He submitted that "the emphasis of the Court is on whether the interest in question is calculated by reference to periods of a year or more".

38. Mr Goy also cited in this regard what Warrington J said in *Re Craven's Mortgage* [1907] 2 Ch 448. Referring to *Bebb v Bunny (supra)* Warrington J said this (at page 457):

> "It has been argued that when the Vice-Chancellor says 'payable de anno in annum' he means to confine his judgment to cases where the interest has to be paid at the end of yearly periods; but he plainly cannot mean that, for interest on purchase money is not payable from year to year, but when the purchase money is paid on actual completion. I think he means interest which may become payable at a future date and is calculable by periods of not less than a year."

39. Mr Goy submitted further that there is no basis for the suggestion that a necessary characteristic of *'yearly interest'* is that it should be payable periodically or that there should be a recurrence of periodical payments. He cited a trilogy of cases all involving situations where interest was payable on a single occasion and was held to be *'yearly interest'*. Thus:

(1) In *Barlow v CIR* 21 TC 354, a trustee acted in breach of trust and to compensate the trust he covenanted by deed in 1930 to pay a principal sum and interest on such sum from 1923, the time of the breach, until the date of the deed. Entitlement to the interest only arose as from the date of the deed. Finlay J held the interest to be yearly interest.

(2) In *Regal (Hastings) Limited v Gulliver* (1944) 24 ATC 297 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. He said at page 299:

> "I have to deal with the facts of this case where the House of Lords has held in 1942 that the defendants, the directors, are to be treated as having had, each of them, since 1935, the sums of £1,402 in trust for the plaintiff, and that the directors must be taken to have invested it at the moment they received it and, therefore, must pay interest from that moment to the time 6 ½ years later, when the House of Lords declared the defendants liable. I think these facts distinguish this case from such a case as Gosling and Sharpe v Blake ((1889) 24 Q.B.D. 324) which dealt with bankers' short loans."

(3) Thirdly, Mr Goy referred me to *Jefford v Gee* [1970] 2 QB 130, which concerned the payment of interest in personal injury cases under the Law Reform

(Miscellaneous Provisions) Act 1934. As to the tax treatment of such interest, Lord Denning MR said as follows at 149C-E:

> "When the court awards interest on debt or damages for two, three or four years, the interest is subject to tax because it is "yearly interest of money": see *Riches v Westminster Bank Ltd* [1947] A.C. 390. Furthermore, seeing that all the interest is received in one year, then, although it may cover two, three or four years' interest, nevertheless, the whole of it comes into charge for tax in the one year in which it is received. This may operate very hardly in those cases where this big sum changes the rate of tax: as for instance, a low taxpayer is brought into a higher rate – or a high taxpayer has to pay much of it away in surtax. But that cannot be helped. The tax man must collect all he can.
>
> There are special statutory provisions about deducting tax. For instance, if the person who pays the interest is a company or a local authority, it must deduct tax and make the payment of interest net of tax: see section 26 of the Finance Act 1969. But, if the person paying is an individual, he must pay the interest as a gross sum, leaving the plaintiff to pay the tax. We do not think that the courts, when awarding interest should get involved in such questions. Interest should be computed and awarded as a gross sum payable by a defendant, leaving him to work out whether he should deduct tax or not."

40. Mr Goy noted that in each of the three cases (a) interest was payable in a lump sum on the happening of a particular event (i.e. the entering into a deed in *Barlow*, or the making of a court order in *Regal (Hastings)* and *Jefford v Gee*[12]) and that (b) prior to such event occurring, there was no entitlement to *payment* of interest. In all of the three cases referred to, the Court simply looked at the period in respect of which the interest was payable. So long as that was at least a year, it was interest "calculable by periods of not less than a year" (*per* Warrington J in *Re Craven's Mortgage* (*supra*)) and as such the interest was yearly interest.

41. On behalf of HMRC, Mr Goy also relied on the same three cases to counter the Joint Administrators' argument that there must be a period of accrual over a *'tract of future time'* for interest to be capable of constituting *'yearly interest'*. Mr Goy submitted that in none of the cases could the interest awarded or agreed be said to accrue unless and until the particular event (see paragraph [38] above); and that in both *Regal (Hastings)* and *Jefford v Gee* no interest could be said to fall due unless and until the Court exercised its discretionary jurisdiction to make such an award, yet it was nevertheless *'yearly interest'* in circumstances where the relevant period which it subsequently compensated for was at least a year.

[12] In *Jefford v Gee*, the relevant yearly interest was awarded by the Court pursuant to a discretionary jurisdiction; namely section 3 of the Law Reform (Miscellaneous Provisions) Act 1934. That provision is referred to in the catch-words of the report in *Regal (Hastings)*, but the Joint Administrators submitted that such reference is erroneous and that properly understood the interest was awarded pursuant to the Court's equitable jurisdiction. As to the basis of the decision, see further below, especially at paragraphs 66 to 68, and footnote 16.

42. Mr Goy submitted further that there was no authority to support the Joint Administrators' contention that accrual over time was an essential characteristic of *'yearly interest'*: whilst accrual over a period is an ordinary feature of interest, and accrual over a period of a year or more is an ordinary feature of *'yearly interest'*, such accrual is not a requirement in either context. He cited additionally in this regard a passage in the speech of Lord Wright in *Westminster Bank Ltd v Riches*, in considering an argument that the payment in question lacked the appropriate element of recurrence for the interest to be interest for tax purposes. The argument failed. Lord Wright said at page 403:

> "It was said that the sum in question could not be interest at all because interest implies a recurrence of periodical accretions, whereas this sum came into existence uno flatu by the judgment of the court and was fixed once and for all. But in truth it represented the total of the periodical accretions of interest during the whole time in which payment of the debt was withheld. The sum awarded was the summation of the total of all the recurring interest items."

43. Mr Goy rejected as "too fine" the Joint Administrators' reliance on the fact that the payment of statutory interest is contingent upon there being a sufficient surplus; it was not a factor which caused the nature of the interest to differ, and indeed had not done in any of the three cases. Mr Goy suggested that the position in this regard is similar to that in the present case, where entitlement to payment of interest only arises if and to the extent that there is a surplus in the administration. Furthermore, he reasoned that if money were lent to a company for a number of years with interest only being payable if profits arose, it would be surprising if the contingent nature of the entitlement to interest precluded it from being 'yearly'.

44. Lastly, in terms of rebutting the Joint Administrators' position that statutory interest does not, as matter of law, constitute *'yearly interest'*, Mr Goy sought to dismiss any suggestion that, to qualify as such, the interest must be payable pursuant to some agreement or accommodation akin to a loan or investment. Further and in any event, he contended that the moratorium imposed by the administration was sufficiently analogous.

45. In this context, Mr Goy accepted that the authorities indicate that where a debt is repayable on demand and there is no agreement for any continued forbearance, any interest payable in respect of such debt would not be 'yearly' interest. He acknowledged that such was the position in *Mayor. &c., of Gateshead v Lumsden (supra)* which concerned a statutory debt in respect of which the plaintiffs had power to allow time for repayment of the debt subject to the payment of interest. The interest was held not to be 'yearly' interest.

46. However, Mr Goy sought to marginalise that case as applicable only if there were no arrangements having the effect of preventing recovery of the debt on demand. He pointed out that Lord Sumner in the Court of Appeal accepted that the position might have been different had the plaintiff followed a regular practice of allowing time to pay, saying at page 889:

> "Whether or not the present case could have been brought into line with the mortgage cases if it had been shewn by the evidence that the corporation followed a regular practice of investing their funds by allowing time to the frontagers for payment of the principal moneys due from them with interest it is unnecessary to consider. It is sufficient for the purposes of this case to say that no such facts are shewn here."

47. Mr Goy submitted that even more obvious than the position contemplated by Lord Sumner is the case where there is an actual agreement allowing time to pay or, as here, an enforced period of forbearance. In such circumstances the interest subsequently payable would be yearly interest, assuming either that the parties agreed to allow deferral of payment for more than a year or that the enforced period of forbearance was envisaged or likely to last for more than a year. In the present case there was no relevant agreement between the parties, but nevertheless the effect of the company going into administration is that there was (and is) an effective moratorium on the ability of the company's creditors to pursue payment of the company's debts. He submitted that, in effect, the result of a company going into administration is for a creditor to be precluded from taking action for recovery of his debt (save in the exceptional cases referred to). For the reasons identified above, such moratorium can in the present case reasonably have been anticipated to last well beyond a year, or at the very least, there was a distinct possibility that this would be the case. Such moratorium has a similar effect to an agreement between parties to a debt agreeing to delay repayment for a year or more: interest payable in respect of such a debt would be yearly interest as interest payable in the present case falls to be so treated.

48. On all these grounds, HMRC sought to dismiss the Joint Administrators' position (that since there is no period during which statutory interest is accruing due it cannot, as a matter of law, constitute *'yearly interest'*) as unsupported and nonsensical in seeking to elevate an ordinary feature of both interest and yearly interest into a requirement that must be satisfied, not for the interest to be interest for tax purposes, but only for it to be yearly interest.

49. HMRC accepted, however, that even if right that it is the length of the period by reference to which the interest ends up being calculated which determines whether it is yearly or annual, they had to overcome the difficulty which the Joint Administrators' submissions in effect finesse, which is the uncertainty at the inception of an administration as to whether or not debts will be repaid within a year. As indicated previously, HMRC adopted alternative arguments in this regard.

50. HMRC's preferred approach, which of course is open to them in the context of an administration that has already lasted some eight years, is the simple one of treating all statutory interest payable out of surplus as being *'yearly interest'* whenever it is calculated and payable in respect of periods in excess of one year. On this approach, HMRC submit that the position should be assessed as at the time when an unconditional entitlement to interest first arose (i.e. as at the time when all the proved debts were paid in full). HMRC accept in this context that "it does not follow that all statutory interest payable under Rule 2.88 will inevitably be 'yearly': if such interest is paid within a year of the commencement of an administration it will not be". That concession may logically be necessary; but given the unusualness of the situation and the actual facts of this case, occasions them no difficulty.

51. HMRC accept that this retrospective approach is a departure from the approach of the Courts, evident from the cases, at least in a contractual context, of looking at the position prospectively from the time the right to any interest first accrues. However, Mr Goy submits that the present case can and should be distinguished because the entitlement to interest here arises exclusively in respect of a past period. He contends that there is no reason to look at the position prospectively because the period in respect of which the interest is payable is clear and finite: the interest will not be payable in respect of any period in the future and thus the future has no relevance.

52. HMRC's alternative approach, lest (contrary to their primary submission) some form of prospective test needs to be satisfied, is that the test should be whether, looking at the position at the time of the commencement of the administration (when what they describe as the 'contingent right to statutory interest' came into existence), the debts in question were likely to go unpaid for a year or more, and thus whether any interest ultimately payable would be payable in respect of a period of a year or more.

53. HMRC have the comfort, in adopting this alternative approach in this particular and unusual case, that the Lehman administration has already lasted more than eight years; and they maintain that "it is reasonable to believe that anyone with knowledge of the business of LBIE would have anticipated that the administration would have taken considerably more than one year to complete…" HMRC also rely on indications in the authorities that even in the contractual context interest will be 'yearly' interest even though there is no certainty that the indebtedness by reference to which the interest is payable will necessarily subsist for more than a year. Thus Lord Donaldson MR said in *Cairns v MacDiarmid* (*supra*) at page 181:

> "Thus interest payable on a mortgage providing for repayment of the money after six months, or indeed a shorter period, will still be annual interest if calculated at a yearly rate, and if the intention of the parties is that it may have to be paid from year to year."

HMRC seek to build on this the submission that even if therefore there was no certainty that the administration would have continued beyond a year and that the relevant debts would be repaid only after a year, the possibility that this *might* occur would mean that the interest would be 'yearly' interest.

54. Thus, HMRC conclude that, whether on their primary or alternative argument, in this case the statutory moratorium imposed by the commencement of administration did, and would always reasonably have been anticipated to, last well beyond a year; and that such moratorium has the same or a similar effect to an agreement between the parties to a debt to delay repayment for a year or more, so that interest payable falls to be treated as *'yearly interest'*.

55. I turn to my adjudication of these competing submissions.

56. To my mind, the starting point is to identify the nature or character of statutory interest and the consequences of that characterisation. I have already stated my view, which conforms with that expressed by David Richards J in *Waterfall IIA*, that the statutory right to interest arises only if and when a surplus is established and does not

accrue over the period between the commencement of the administration and the payment of dividend or dividends on the proved debts (see paragraph [14] above).

57. In my view, HMRC's arguments do not adequately recognise the particular nature or character of the statutory interest payable out of surplus. Although it is common ground, and I accept, that such statutory interest is indeed "interest" for the purposes of tax legislation within the broad definition given in *Westminster Bank Ltd v Riches* (*supra* at paragraph [7]), it is "interest" of a very different nature from that payable on contractual debts, judgment debts or other analogous debts (such as in the administration of a deceased's estate), as David Richards J also made clear (see paragraphs [109] to [114] and [145]) in his judgment in *Waterfall IIA*. The right to payment out of a surplus of statutory interest pursuant to Rule 2.88(7) is in the nature of an arrangement statutorily imposed on the creditors for the equitable distribution of surplus. Put another way, as indeed it was put by Lord Romilly MR in *In re Herefordshire Banking Company* (1867) LR 4 Eq 250 at 252-3[13]:

> "It is in point of fact a decree amongst a great number of co-partners to settle their equities among themselves, and to wind up the affairs of the partnership, but that does not give the creditors of the partners a judgment against the company, or entitle them to any interest in respect of it."

58. This purely statutory entitlement under the scheme of distribution seems to me to be some way away from any of the cases where a payment or commitment to pay interest has been determined to be in the nature of *'yearly interest'*. There is no loan; no investment; no judgment; no period of accrual; no right unless and until a surplus is established; no quality or capability of recurrence; there is only a moratorium and a scheme of distribution mandated by the statute and the Rules.

59. *Gateshead Corporation v Lumsden (supra)* demonstrates that the fact that money remains for more than a year outstanding and interest-bearing does not suffice (see *per* Lord Sumner at page 888). Something akin to a loan or investment "at interest" must also be demonstrated or be capable of being inferred from the evidence *(ibid.*); and in that context forbearance is not enough (*ibid.* at pages 889-890).

60. *Garston Overseers v Carlisle (Surveyor of Taxes)* [1915] 3 KB 381 is to the same effect (and see especially pages 386 to 387 in the judgment of Rowlatt J). In *Corinthian Securities Ltd v Cato* [1970] 1 QB 377, the Court of Appeal again emphasised the pre-requisite of some form of investment or loan intended by the parties to remain outstanding and attract and accrue interest for a period of more than one year. The cases further emphasise the requirement of such intention: and see also *Cairns v MacDiarmid (Inspector of Taxes) (supra).*

61. Accrual over the course of the loan or investment is a requisite characteristic of a loan or investment; the intended basis of the loan or investment must be accrual of interest over "a tract of future time" (the useful phrase deployed in the Scottish cases, especially *Scottish North American Trust, Limited v Farmer (supra)* and *CIR v Sir Duncan Hay, Bart* (1924) 8 TC 636 (which contains a useful review of the cases up to

[13] Also quoted by David Richards J in *Waterfall IIA* at paragraph [113].

that point by the Court of Session)). I accept that it is also clear that the word *'yearly'* and 'annual' denote the further quality of being recurrent or at least being capable of recurrence: see *Moss' Empires, Ltd. v IRC (supra)* at p795.

62. Contrary to Mr Goy's submissions on behalf of HMRC, I cannot accept that any intention to make anything akin to a loan or investment is discernible or to be inferred from the fact of the statutory moratorium, which is imposed by the Act and has nothing to do with any intention of the parties. The fact that no interest is payable unless and until a surplus is available, and the fact that there is no accrual, nor any prospective expectation of it, amply demonstrate, in my judgment, that any interest payable out of surplus has none of the characteristics of *'yearly interest'* save that payment would in this case be in respect of a period of over a year which, as explained above, does not suffice. More generally, and as I have stated above, the scheme of distribution cannot sensibly be equated to an arrangement for the payment of *'yearly interest'* within the scope or contemplation of Section 874.

63. Nor, for that matter, can I accept Mr Goy's suggestion that there is in this case any real element of recurrence (which, I record, he did accept was a requisite characteristic of *'yearly interest'*). Mr Goy placed reliance in this context on the passage in the speech of Lord Wright in *Riches v Westminster Bank Ltd. (supra)* quoted in paragraph [42] above, and in particular, the recognition in it that a single award of interest on and by judgment was nevertheless "a sum of profit, not capital" and constituted "interest" accordingly (see page 403) even though the "sum came into existence uno flatu by the judgment of the court".

64. However, the real issue in *Riches v Westminster Bank Ltd* was whether the payment in respect of interest was interest at all, it being the contention of Mr Riches that it was "not interest in the true sense but was part of a lump sum…given as compensation for the detention of money due to the appellant. So, being an indemnity for damage done, it is not income" (see the argument of his counsel as summarised at page 392). The decision that the sum awarded was indeed "the summation of the total of all the recurring interest items" (page 403) and constituted not a capital sum but a sum of accumulated profit by way of interest does not assist in determining the characteristics of *'yearly interest'* or HMRC in this case.

65. Perhaps the nearest that HMRC got to a supportive line of authority was the trilogy of cases referred to previously, namely *Barlow v CIR, Regal (Hastings)* and *Jefford v Gee (supra).* But the differences between those cases and the present remain stark, and on closer analysis, in my view, none of those cases provides any real guidance.

66. *Barlow v CIR* concerned the characterisation of sums payable by way of compound interest under a deed of covenant made by a trustee to make good his breaches of trust in investing in unauthorised securities in his own name which subsequently fell in value. There were two issues: whether the sum to be paid by way of rolled up interest was in truth a capital sum or interest; and if the latter, whether the payments constituted *'yearly interest'*. Reversing the Special Commissioners on both points, Finlay J held that the covenant for payment of compound interest was just that, and constituted interest even if paid as a single aggregate sum, and that since the commitment was intended to recognise and fulfil an equitable obligation to make good the trust fund in respect of interest it had lost (or should otherwise have

gained)[14] and to extend over a period of more than one year, it was *'yearly interest'*. With respect to the Special Commissioners, it is not easy to see how the case could have been decided otherwise. As Finlay J put it (at page 363):

> "The beneficiaries were entitled not merely to the principal, they were entitled to the fruits of it, they were entitled to the interest, and they got interest. I say the beneficiaries because I think it was agreed, and anyhow it seems to me to be clear, that the fact, which is a fact, that there was nobody here in the particular years in question entitled to the income beneficially, is immaterial. It would have been the same if there had been a cestui que trust. I do not think the circumstance that in the facts here the money had not to be paid out to anybody but had to be accumulated makes any difference."

67. *Regal (Hastings) Limited v Gulliver (supra)* is to the same effect, though in that case the relevant obligation to pay interest was recognised and its fulfilment directed by order of the House of Lords in a preceding case with the same title, rather than in a Deed of Covenant. More particularly, the House of Lords, in its subsequently celebrated decision (not reported in the Law Reports until 1967)[15], held that the defendants, though they had acted bona fide, were bound as directors of their company (owing fiduciary duties to it accordingly) to account to the company for all profits they had made out of using their position as directors to deal in certain shares, with interest at 4 per cent. from the date of the dealings. When the matter came before Cassels J after that decision in the House of Lords, the question, as in *Barlow*, concerned the proper tax treatment of the interest ordered to be so paid. Cassels J, in holding that this was 'yearly interest', proceeded on the following basis (see page 299):

> "I have to deal with the facts in this case, where the House of Lords has held in 1942 that the defendants, the directors, are to be treated as having had, each of them, since 1935 the sum of £1,402 in trust for the plaintiff, and that the directors must be taken to have invested it at the moment they received it, and, therefore, must pay interest from that moment to the time, 6½ years later, when the House of Lords declared the defendants liable. I think these facts distinguish this case from such a case

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[14] Finlay J referred to and relied on *Vyse v Foster* (1872) 8 Ch App 309 (which was affirmed in the House of Lords), and quoted a passage in the judgment of James LJ in the Court of Appeal (at page 329) as follows:

> "If an executor commits a breach of trust, he and all those who are accomplices with him in that breach of trust are all and each of them bound to make good the trust fund and interest. If an executor or trustee makes profit by an improper dealing with the assets of the trust fund, that profit he must give up to the trust. If that improper dealing consists in embarking or investing the trust fund in business, he must account for the profit made by him in such employment in such business; or at the option of the cestui que trust, or if it does not appear, or cannot be made to appear, what profits are attributable to such employment, he must account for trade interest, that is to say, interest at 5 per cent. in this case…"

[15] [1967] 2 AC 134.

> as *Gosling and Sharpe v Blake*…which dealt with bankers' short loans."

68. In my opinion, it is clear from that passage that the sums payable by way of interest represented the further profits which the directors had, or should in equity be treated as having, gained year on year from the investment (actual or deemed) of the principal[16].

69. I have puzzled over Cassels J's concluding remarks at the end of his judgment (on page 300) in addressing the question raised as to whether the rates of interest applicable should be those prevailing each year between 1935 and 1942 or that applicable in 1942, and especially his statement, in deciding that the 1942 rate should be applied, that "this was a case of interest which nobody knew would be payable, and the rate of which was unknown, until the House of Lords gave its decision and indicated the rate" and that he did not "think the amount of interest became due until the date of that decision". I acknowledge that, read alone, these comments may be taken as supporting HMRC's case that it is not necessary for interest to accrue over more than year for it to be characterised as 'yearly interest'. However, I have concluded that these remarks do not upset the overall analysis that the directors were bound to account for the interest they had or were deemed to have gained yearly over the course of many years, and the requirement to account, though not enforced until later, reflected the actual or deemed accrual of interest over the (nearly) seven-year period in question. As I read the earlier part of Cassels J's judgment (at page 299), it was on that basis that he characterised the interest as 'yearly interest'. I do not consider that the later remarks should be taken as altering that basis; and if there is a tension in the judgment, I prefer and would follow what I regard as that basis for his decision (that is, as stated at page 299).

70. So regarded, the case is in line with *Barlow* and, in my view, provides no further support for HMRC accordingly.

71. The third in the trilogy of cases especially relied on by HMRC is *Jefford v Gee (supra)*. This is of a different nature, being (as previously noted) a case concerning the payments of interest as a lump sum in personal injury cases, but (in my view) it provides no real support for HMRC either. There are a number of points that undermine HMRC's reliance on it:

    (1) The focus of the case was as to how the Courts should apply the (then newly enacted) Administration of Justice Act 1969's provisions for the mandatory award of interest on damages in personal injury cases (see page 142A).

    (2) There does not appear to have been substantial argument on the question of deduction of tax. It is less surprising, therefore, that the Court of Appeal proceeded on the footing of a misunderstanding (introduced by Counsel) as to the scope and effect of the decision in *Riches v Westminster Bank.* Lord Denning MR referred in passing, at 149C, to the interest being taxable because it

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[16] I agree, therefore, with the Joint Administrators' submission that in requiring the payment of interest the House of Lords was exercising its equitable jurisdiction (see footnote 12 above).

was yearly interest and noted *Riches v Westminster Bank*. 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 would still have been chargeable to tax within Case III of Schedule D.

(3) Furthermore, the Court of Appeal did not decide any issue as to the proper characterisation of the interest: at page 149D–E, Lord Denning 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."

(4) Moreover, the nature of the obligation was a judgment debt. That is not the position in this case; as explained in *Waterfall IIA* by David Richards J, at paragraphs [109] to [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.

(5) It should also be noted that the position in relation to judgment debts is not as clear as may have been supposed (cf. *In re Cooper* referred to at paragraph [31] above, especially at pages 553-4).

72. In short, I do not consider that the trilogy of cases which ultimately Mr Goy on behalf of HMRC put at the forefront of his submissions displays any solid basis for their contentions.

73. My conclusion that HMRC's basic analysis is incorrect, and that 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), removes the need to consider and seek to resolve the practical difficulties to which both their primary and their alternative arguments would give rise. However, those difficulties also further lean against HMRC's arguments that the legislative intention is for the statutory interest to be *yearly interest* and add further support for the view that indeed, as the detailed analysis of David Richards J demonstrates, the legislative intention is all to the contrary, since the interest does not accrue.

74. As to HMRC's primary argument, the Joint Administrators identified the following difficulties and concerns:

(1) First, 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. Even in administrations which become distributing administrations and in which creditors have their proved debts paid in full, it is quite possible that some creditors will receive payment of 100p in the £ prior to the first anniversary of an administration, but that others will not. There may be disputed debts which the administrator has provided for in full but which are not admitted prior to the end of the first year of the administration.

(3) Such a realistic possibility 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 of the administration are to have income tax deducted from the statutory interest paid to them.

(4) Such an outcome would be wholly unprincipled and without merit.

(5) It 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. It might, for example, lead to 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.[17]

75. It would, in any event, be an odd and unsatisfactory result for deductions to be made from statutory interest:

(1) payable to some creditors but not others in the same administration; and

(2) in some administrations but not in others.

76. HMRC's alternative argument would raise yet more questions and difficulties. As the Joint Administrators put it in their skeleton argument, "It would be odd, and raise yet more questions, if the obligation to deduct depended on how long it was considered the administrator would be likely to take to pay the proved debts, determined as at commencement".

77. Most obviously, and as the Joint Administrators pointed out:

(1) It will, in fact, be unclear at the commencement of the vast majority of administrations whether or not the administration will become a distributing administration and, if so, when distributions will be made and in what amount. That was certainly the position in LBIE's administration.

(2) There would be a significant problem in evidencing the matter and, in many cases, distributions will end up being made more quickly or less quickly than

[17] 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.

might have been expected at the beginning of the process (if there was any expectation of distributions at the beginning of the process at all).

(3) It is unclear how there could be any definite answer if it was likely that the debts would be paid in approximately a year's time after commencement.

(4) The question plainly cannot be answered with the benefit of hindsight because that would amount to precisely the same test as HMRC's primary argument, which I have rejected.

Conclusion

78. In summary and conclusion, for the reasons I have sought to give, I have reached the conclusion that the statutory interest to be paid under Rule 2.88(7) is not *'yearly interest'* within the scope and meaning of section 874, and thus no obligation to deduct tax arises.

79. I would ask Counsel to agree a suitable order to that effect.

80. Lastly, although not the basis for, or even a factor in, my decision, I feel it is right that I should address one further matter, which is the statements made on behalf of HMRC in its correspondence and in section 7433 of its Insolvency Manual ("section 7433 INS"), which have resulted in some regrettable confusion.

81. Put shortly, until late 2015 HMRC's stated (and twice confirmed) position was that in accordance with INS 7433 any statutory interest paid in the course of the administration (or subsequent liquidation) could be paid without any obligation to deduct income tax. However, when in August 2015 and in anticipation of actually making distributions, the Joint Administrators asked HMRC to reconfirm their position, the matter was apparently referred by a newly appointed Customer Relationship Manager to the specialist team within HMRC known as the CTIS Financial Products Team ("the CTIS Team"). The CTIS Team, I am told, has responsibility for HMRC policy in respect of the issue of deduction of tax at source and the related legislation. The upshot of the reference was a reversal of HMRC's previous position, HMRC now taking the view that (a) contrary to the confirmations previously given, statutory interest payments should be subject to deduction and (b) section 7433 INS had been misconstrued, and applied only to payments of statutory interest to HMRC and not to payments to other creditors. In further exchanges of correspondence, HMRC's new position hardened, necessitating resolution by way of Court application.

82. HMRC have expressed regret that they had earlier made contrary statements, and have described the failure to refer the matter to the CTIS Team before giving the written confirmations of their position as "unfortunate". They have also sought to characterise section 7433 INS as intended to have effect only in relation to payments in an insolvency to HMRC themselves, but accept that it is easily capable of being read (as indeed it had been read, including by HMRC themselves) as having a broader application.

83. It is not necessary for me to construe section 7433 INS. Further, I should note that it is not suggested by the Joint Administrators that the repeated confirmations by HMRC

gave rise to any estoppel: and in the event, my conclusion is in conformity with HMRC's original confirmations and the construction of section 7433 INS on which they were based, so that on my view of the matter reliance on any estoppel would be unnecessary.

84. However, it does seem to me, as I made clear in the course of the hearing, that I should remind HMRC how unsatisfactory it is that they should issue inconsistent or confusing statements in this way, and fail to involve a relevant specialist team and/or make proper internal checks when giving formal confirmations of their position which they must expect to be relied on. It is not only that it is inherently unsatisfactory and regrettable when government departments give materially inconsistent formal statements or guidance. It is also that, in a case such as this, debt is traded; and a change in the stance of HMRC may confound the commercial assumptions and expectations of the traders and the market. It is of real importance, both in terms of good governance and a fair market, that HMRC should make every effort to ensure that this sort of thing does not happen again.

APPENDIX

History of the deduction of yearly interest — a brief summary[18]

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.[19] 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[20] 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[21]; 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.[22]

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, s 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.

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[18] 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.

[19] (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.

[20] (1803) 43 Geo 3 c 122.

[21] 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.

[22] 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.

5. Thus at inception the deduction of tax at source in respect of interest only applied to yearly interest. Non-yearly interest was not generally charged to tax.

6. The Income Tax Act of 1805[23] 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 s 192 of the 1805 Act—which, if paid out of profits or gains, was deductible at source—and non-yearly 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.[24]

7. The legislation was consolidated in the Income Tax Act of 1806 (see s 114 and Schedule D in that Act).[25]

8. Income tax was abolished in 1816, but reintroduced by Sir Robert Peel in 1842. Following the scheme of the 1803–6 Acts, s 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, s 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 s 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 simply taking the tax rate at the time the interest became due.

11. The position essentially continued until it was altered by s 24(3) of the Customs and Inland Revenue Act 1888, which made it compulsory to deduct tax at source where

[23] (1805) 45 Geo 3 c 49.

[24] i.e., as stated by s 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).

[25] (1806) 46 Geo 3 c 65.

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.[26]

13. The legislation was consolidated in the Income Tax Act 1918, which preserved this dichotomy.[27] 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: s 169 (concerning yearly interest and other annual payments paid out of profits or gains wholly charged to tax) corresponds to r 19 of the General Rules in the 1918 Act; and s 170 (concerning interest of any kind that was not paid out of wholly taxed income) corresponds to the former r 21.

15. The Finance Act 1965 created Corporation tax. Section 48(5) disapplied the permissive rule in s 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 s 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.[28]

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[26] Subsequently, FA 1927, s 39 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.

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

[28] 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.

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"*.