IN THE COURT OF APPEAL **REF**

(CIVIL DIVISION)

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:

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS

Appellants

- and -

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

Respondents

SKELETON ARGUMENT ON BEHALF OF THE APPELLANTS

Suggested pre-reading: (1) the skeleton arguments of the parties; (ii) the decision of the High Court. Estimated pre-reading time required 2 – 3 hours.

INTRODUCTION

1. Lehman Brothers International (Europe) ("**LBIE**") has been in administration since 15 September 2008. There is a surplus in the administration which is to be used, amongst other things, to pay statutory interest to creditors under the provisions of the Insolvency Rules 2.88(7) ("**Rule 2.88**"). The question arising in this Appeal is whether such interest, when paid, will rank as "yearly interest" for the purposes of section 874 Income Tax Act 2007 ("**Section 874**"). If it does, the Respondents will be required, subject to specific statutory exceptions applying, to deduct basic rate income tax from the payments made and account for them to the Appellants. If the interest is not "yearly interest" no such obligation will exist, and payments will be made gross. Section 874 provides as follows:-

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

The significance of tax being deducted at source is explained in the annex hereto.

2. In order for interest to be "yearly interest" as opposed to other interest, it must have some quality that links the interest to a period of a year or more. In the Appellants' submission such quality is nothing more than that the interest, when an unconditional entitlement to it first arises, must be payable in respect of a period of a year or more. Nothing else is required. So, in the present case, entitlement to the payment of interest only arises if and when all debts proved in the administration have been paid and if and to the extent there is a surplus. It is then payable in respect of the period from the time such debts are outstanding since the company entered administration. In the present case, such period will, in all cases, exceed a year. On this basis, the interest is "yearly interest".

3. In the High Court, Mr Justice Hildyard did not accept the Appellants' submission. While he says that the interest in question is "sui generis" (see High Court Judgement ("HCJ") para 16), and is very different from interest on contractual debts or the like, he, nevertheless, concludes that the interest would not be "yearly interest" on the basis that the interest lacked the characteristics of yearly interest as appear in cases concerning contractual debts and the like. More particularly, he concludes that the interest lacked such characteristics of:

(i) accrual (see HCJ para 62);

(ii) recurrence (see HCJ para 63);

(iii) an investment or loan (see HCJ paras 60, 62).

In the Appellants' submission, the Judge was wrong to consider that such characteristics must exist before interest can be yearly interest. In order for interest to be yearly interest the only additional requirement in the Appellants' submission is that there must be a link between the payment of interest and the period of a year or more. That link is not proved or disproved by the existence of those characteristics identified by the Judge.

The nature of the statutory interest

4. Rule 2.88(7), in the form in which it applies to LBIE, 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."

5. The nature of the interest payable is summarised by David Richards J (as he then was) in one of the LBIE cases, Waterfall IIA, (see [2015] EWHC 2269 (Ch) at para 149):-

> "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."

6. When David Richards J says that the statutory interest is not a right *to the payment* of interest "accruing due from time to time" he can only say this because 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. But for such contingency the right to interest would "accrue due" from time to time.

THE NATURE OF YEARLY INTEREST – THE APPELLANTS' POSITION

7. It is not disputed in the present case that Rule 2.88 interest constitutes "interest" for tax purposes. While the term "yearly interest" is not defined in relevant tax legislation, there are a number of cases that cast light on its meaning. Most of these involve loans where interest is payable under the terms of such loans.

8. In Bebb v Bunny [1854] 1 K&J 216 the Vice Chancellor considered whether a purchaser liable to pay interest to the vendor could deduct income tax from such payment. The court said at p219:-

> "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."
>
> **[emphasis added]**

It should be noted that the Vice Chancellor does not say that interest can only be "yearly" interest if it "accrues" over a period. He merely says that if it does so, and may be payable from year to year, it will be.

9. Bebb v Bunny may be contrasted with Goslings & Sharpe v Blake 2 TC 450 in which the Court of Appeal held that interest on a banker's loan for a specified time less than a year (in that case 3 months), although expressed as being a percentage rate 'per annum', did not constitute yearly interest. Bowen LJ said as follows at p456:-

> "We are dealing in this case only with short loans, 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 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 loan would last for a year, therefore it is not yearly interest when the loan does not last beyond the short period, and the interest does not run over it. When it runs over, then the interest becomes calculable during the time it runs over it, it becomes calculable with reference to the time it is outstanding, and with reference to a year, and the case may be different there."
>
> **[emphasis added]**

10. The upshot of the decisions in the above two cases is that interest is yearly interest if it is payable in respect of a debt that will, may or does 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. The position in this respect is confirmed by what Warrington J said in Re Craven's Mortgage [1907] 2 Ch 448. He refers to Bebb v Bunny (supra) and says (at p457):-

> "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."
>
> **[emphasis added]**

What should be noted is that in both Goslings & Sharpe v Blake (supra) and Re Craven's Mortgage (supra) the emphasis of the Court is on whether the interest in question is calculated by reference to periods of a year or more. The essential requirement is the existence of an adequate link between the interest payable and the period of a year or more.

11. The existence of such link with the period of a year or more sufficient to make interest "yearly" may vary dependent upon the nature of the interest in question. In the case of contractual loans the link is found in the length of the period that the loan will exist for and thus the length of the period over

which interest is likely to be payable. Thus in Cairns v MacDiarmid [1983] STC 178 Sir J Donaldson MR said at p181:-

> "It is well settled that the difference between what is annual and what is short interest depends on the intention of the parties. 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 (Bebb v Bunny (1854) 1 K&J 216, 69 ER 436 and Corinthium Securities Ltd v Cato (Inspector of Taxes) [1969] 3 All ER 1168, 46 TC 93)"

No reference is made in such a case to the position of statutory interest being payable in a case such as the present, where the entitlement to payment of interest only happens on the occurrence of an event. Nevertheless the question remains – is the interest calculated and payable by reference to a period of a year or more?

12. In a contractual case the question of whether interest is "yearly" interest is looked at at the time the right to interest first arises. Whether the interest can be said to be calculated and payable by reference to a period of a year or more is determined by reference to the intentions of the parties regarding the length of the loan (see Cairns v MacDiarmid (supra)). Where interest is payable in circumstances such as the present, in which the right to interest when it arises relates to a period that is already past, the question of whether interest is calculated and payable by reference to a period of a year or more can be determined without reference to the intention of the parties. Reference can

be made quite simply to the period in respect of which the interest is payable.

13. There have been a number of cases which support the Appellants' approach:

(a) 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.

Mr Justice Hildyard saw this decision of little guidance in the present case because the interest paid was intended to recognise and fulfil an equitable obligation to make good the trust fund (see HCJ para 66). In the Appellants' submission while what the Judge says is correct it fails to recognise the essential similarity with the present case. Ultimately in Barlow the obligation to pay interest was that which arose under the deed and was distinct from any other obligation that existed prior to such deed being executed. When that right arose the interest related to a period prior to the time the right arose. It was a period in excess of a year and the interest was held to be yearly interest.

(b) Regal Hastings v Gulliver (1944) ATC 297. The directors in that case, profiting 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 p299:-

> "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 & Sharpe v Blake [ref.] which dealt with bankers' short loans."

And at p300:-

> "This is 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. I do not think the amount of interest became due until the date of that decision."

Again, Mr Justice Hildyard seeks to distinguish this case from the present on the basis of there having been a pre-existing obligation to pay interest notwithstanding the preceding quote which clearly indicates how Cassels J saw the point (see HCJ para 68 and 69). In the Appellants' submission Mr Justice Hildyard was wrong to ignore the approach of Cassels J. Any obligation to

payment interest was ultimately dependent upon the exercise of discretion by the court. In this sense, entitlement was contingent upon the making of the court order. So in this case entitlement was likewise contingent upon the happening of an event (i.e. the existence of a surplus in the administration after the payment of all debts).

(c) Jefford v Gee [1970] 2 QB 130. The case 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 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 [ref.]. 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 s.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."

Again the Judge refused to place reliance on this decision largely on the basis that the award of interest on a lump sum paid in personal injury cases is mandatory (see HCJ para 71). As to this the Appellants say that:-

(i) whether mandatory or not, any award of interest was dependent upon an award of damages being made – such obligation ultimately being dependent upon a court order;

(ii) the award of interest was not in any event mandatory as can be seen from the terms of the legislation in question (see Jefford v Gee (supra) at p131).

14. It should be noted that it is not part of the Appellants' case that where interest turns out to be payable in respect of a period of a year or more that such interest is automatically yearly interest. Such a claim would be inconsistent with the decision of the Court of Appeal in Gateshead Corporation v Lumsden [1914] 2 KB 883. In that case the interest when paid was paid in respect of a period in excess of a year. Nevertheless, when the right to interest first arose it was payable in respect of a

debt repayable on demand. In that case, the character of the interest was determined as at the date the obligation to pay it first arose just as in other cases (see, for example, Cairns v MacDiarmid (supra)). In the present case when the right to interest first arises, it is not an obligation to pay interest as to the future, the period of such debt being wholly uncertain, but rather as to the past. The past period in respect of which it is payable is certain and exceeds a year.

15. The contrast between the present case and a case such as Gateshead Corporation v Lumsden (supra) appears to have been seen by Cassels J in Regal Hastings v Guliver (supra). He saw it as of no assistance (see p299). For the reason given in the preceding paragraph he was right to take this view.

16. In the Appellants' submission, the Judge failed to take guidance from the three cases referred to in paragraph 14 above. The three cases were all concerned with interest being payable in a lump sum on the happening of a particular event (ie the entering into a deed in Barlow, or the making of a court order in Royal Hastings and Jefford v Gee). Prior to such event occurring there was no entitlement to the *payment* of interest.

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. In all 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 the interest was yearly interest. It was interest "calculable by periods of not less than a year" (per Warrington J in Re Craven's Mortgage (supra)). The position is the same in the present case and the Judge should, accordingly, have held the interest to be "yearly interest".

The Judge's approach

17. Rather than adopting the approach referred to above, the Judge while stating that the statutory right to the interest in question is "sui generis", then proceeded to identify the characteristics of yearly interest by reference to the factual characteristics of cases concerning contractual debts and the like. In the Appellant's submission, the Judge failed to identify the true criterion that must be satisfied before interest can be yearly interest namely the required link between the payment of interest and the period of a year or more. The actual

characteristics he refers to, while often characteristics of yearly interest, are not requirements that must be satisfied in order for it to be so.

No Accrual

18. The Judge denies that the interest accrues (see HCJ para 17) adopting the view of David Richards J in the Waterfall 11A application [2015] EWHC 2269 (see HCJ para 9). He relies on the absence of accrual as indicating that the interest is not yearly interest (see HCJ para 62).

19. On the Judge's view, interest only payable contingently on the happening of an event or other satisfaction of a condition cannot be yearly interest. This is the position as asserted by the Respondents in the High Court. It would follow, therefore, that if money were lent to a company for a period of years with interest only being payable if a level of profit had been reached after such period had elapsed, such interest would not be "yearly interest" because it had not accrued over such period. In the Appellant's submission, this would not only be a surprising conclusion but is wholly wrong. The absence of

accrual on a day to day basis is not something that can realistically be said to preclude interest when paid being "yearly". Accrual of itself has nothing to do with a period of a year with which the distinction between yearly interest and other interest is on its terms concerned. The Judge fails to explain why the contingent nature of a right to interest can somehow affect whether, when paid, it is yearly or not.

20. As to the Judge's view, the Appellants make the following further points:

(i) There is no authority supporting the Judge's view. The position is quite the contrary. In all of the cases referred to in paragraph 13 above, the courts concluded that interest was "yearly" despite none of the interest accruing in the strict sense referred to by the Judge. In both Regal Hastings and Jefford v Gee, in particular, no interest could be said to fall due unless and until the Court exercised its discretionary jurisdiction to make an award. It was nevertheless held to be "yearly interest" in circumstances where the relevant period in respect of which it was paid exceeded a year.

(ii) If there is no accrual in the present case, it can only be because of the contingent nature of the entitlement to receive payment of the interest. It is submitted that the difference between the payment of interest being unconditional or contingent is too fine to cause the nature of the interest to differ in each case (as the cases of Regal (Hastings) Limited v Gulliver and Jefford v Gee confirm).

(iii) In the High Court the Respondents made reference to earlier statutes which assumed, in cases where yearly interest was or could be subject to deduction of tax, that "yearly" interest was interest that accrued over a period (see HCJ para 29). Rules provided for the rate of deduction by reference to the average of tax rates over which the interest accrued. In the Appellants' submission it is wrong to take from this the assumption that yearly interest must accrue in the strict sense referred to. The legislation referred to merely recognises that in the ordinary case of interest paid pursuant to a contract there will be such accrual.

21. In the Appellants' submission the Judge's conclusion regarding accrual elevates an ordinary feature of both interest and yearly interest into a requirement that must be satisfied, not for interest to be interest per se but only for it to be yearly interest. There is no support for such an argument nor is there sense in it. Accrual of itself has nothing to do with a period of a year or more with which the distinction between interest and "yearly" interest is on its term concerned.

No Recurrence

22. In the Appellant's submission the Judge makes the like mistake when he concludes that there is an absence of an element of recurrence to the interest sufficient to make it "yearly interest" (see HCJ paras 61, 63, 64).

23. The point made in this case is similar to that put in Riches v Westminster Bank [1947] AC 390 where it was argued that the interest payable in that case, being interest on a judgment debt, lacked the appropriate element of recurrence in order for it to be interest. Lord Wright said at p403:

> "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."

(see also V Simons at p398; Lord Simonds at p410).

24. So in the present case, the Respondents do not claim that the interest in question is not interest for tax purposes. They therefore accept that a sufficient degree of recurrence exists. Nevertheless, the Judge distinguishes Riches v Westminster Bank on the basis that that case was concerned with whether the payment was interest at all (see HCJ para 64). But if such a payment in Riches had sufficient element of recurrence in order for it to be interest it is difficult to see why such element is lacking in the present case. Under Rule 2.88(7) interest is payable in respect of the period prior to the time the debts are repaid. As said by David Richards J in Re Waterfall 11A (supra) at para 152:-

> "Once their proved debts have been paid in full, and there is a surplus available, they will receive interest on these proved debts for the periods commencing with the start of the administration while they were outstanding."

In the same way as in Riches, the interest paid represents "the total of the periodical accretions of interest during the whole time in which payment of the debt was withheld".

25. The Judge fails to realise that the requirement for recurrence (which is a requirement before a payment can be interest) relates to the quality of the payment nothing further. There is no basis for saying that there is any different or additional requirement before interest can be yearly interest. Certainly there is no requirement that it must be payable periodically (see Re Craven's Mortgage) (supra)).

No loan or investment

26. The Judge stresses the distinction between Rule 2.88 interest and that payable in respect of contractual debts and the like (HCJ para 57). He refers to the fact that there is "no loan; no investment; no judgment" (HCJ para 57). In the Appellants' submission all that follows from this is that the interest in question is payable in different circumstances to that payable in cases that have previously come before the courts. What he fails to explain is why the absence of a loan or

investment etc means that the additional requirement of interest being "yearly" before it can be "yearly interest" cannot be satisfied. In the Appellants' submission, features relevant to the question of whether interest is yearly interest must relate the interest to a period of a year or more. The absence of there being a loan or investment does not have any such relevance.

27. The Judge refers to cases which mention to the need for there to be some form of investment or loan (see HCJ para 60). He makes no specific mention of what Lord Donaldson MR said in Cairns v MacDiarmid (supra) at p181:-

> "I would personally wish to avoid the use of the term "investment" as providing any sort of test in the context of whether interest is annual interest ...because it is possible to have a short-term and indeed a very short-term investment, eg overnight deposits, and such an investment does not involve any annual interest ..."

CONCLUSION

28. In conclusion the Appellants submit that the Judge failed to identify the correct approach to be applied to determine whether or not the interest in question is yearly interest. Had he done so the only conclusion he could properly have come to would be to hold that it is.

29. It is to be noted that the Judge refers to the "legislative intention" as indicating that the interest in question should not be yearly interest (see HCJ para 73). In the Appellants' submission any search for the legislative intention is of no help. The only realistic conclusion is that the payment of interest was provided for by Rule 2.88(7) without reference to whether the interest would be yearly interest for the purposes of tax. If any consideration had been given to the point, express statutory provisions would have been included as they have been, certainly in one other context (see s.888 Income Tax Act 2007).

30. It appears that in coming to his conclusion, the Judge was influenced by practical difficulties that could arise if the Appellants are correct (see HCJ paras 73 to 77). As to the points made, the Appellants comment as follows:

(i) None of the points referred to have any bearing on the meaning of yearly interest.

(ii) It is not suggested that there are any practical difficulties in the present case, whatever might be the position in other cases.

(iii) Solvent administrations are rare and hence the payment of Rule.2.88 (7) interest is rare.

(iv) It would be wrong to distort the meaning of "yearly interest" to deal with practical difficulties. It is for Parliament to regulate to avoid difficulties arising if it is so minded.

31. For the foregoing reasons, it is submitted that the Appellants' appeal should be allowed. The Rule 2.88 interest payable in this case should be held to be "yearly" interest for the purposes of section 874.

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26th October 2016

ANNEX

As regards residents of the UK the system of deduction of tax at source provides security to HMRC for the collection of tax.

As regards non-resident recipients of yearly interest the existence of an obligation to deduct tax also affect the obligation of such persons to pay tax. In broad terms the effect of sections 811 (read with s.813 and s.825) ITA 2007 and section 815 (read with s.816 and s.825) ITA 2007 results in such income not being taxable unless tax is deducted at source.

It should be noted that non-residents who receive yearly interest subject to deduction of tax at source may have their ultimate liability affected by the terms of an applicable double tax treaty. Treaties commonly give the taxing right in respect of interest in whole or in part to the place of residence of the recipient. In these circumstances any tax deducted may have to be repaid by HMRC in whole or in part, upon the making of a claim under the relevant treaty. Where there is no applicable double tax treaty the liability of the non-

resident will depend, in effect upon whether income tax is deducted at source.

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SKELETON ARGUMENT ON BEHALF OF THE APPELLANTS
