NO. 1320—HIGH COURT OF JUSTICE (KING'S BENCH DIVISION)—21ST, 22ND AND 25TH OCTOBER, 1943

COURT OF APPEAL—14TH, 15TH AND 16TH MARCH, 1944

HOUSE OF LORDS—12TH, 13TH AND 14TH MARCH, AND 19TH APRIL, 1945

COMMISSIONERS OF INLAND REVENUE *v.* OSWALD (TRUSTEE OF THE COSIER SETTLEMENT) (1)

Income Tax—Mortgage of reversion under settlement—Mortgage interest capitalised—Falling in of reversion—Settled funds, being less than amount of advances plus capitalised interest, handed over to mortgagee by settlement trustee—When interest paid—Person " by or through whom " payment made —Income Tax Act, 1918 (8 & 9 *Geo.* V, *c.* 40), *General Rule* 21.

In 1899, 1901 *and* 1905 *B mortgaged her reversionary interest under a settlement to L as security for certain advances. The* 1905 *mortgage deed provided that thenceforward interest on all the advances should be at the rate of* 5½ *per cent. per annum payable quarterly, reducible to* 5 *per cent. on punctual payment, and that all interest not paid within* 21 *days of the due dates should, at the option of the mortgagee, be capitalised and added to the principal. No interest was paid by B after* 1906. *In* 1920 *L died and her trustees took her place. B died in* 1933, *and on 9th August,* 1935, *L's trustees executed an instrument under which they capitalised as from 18th May,* 1935, *so much of the interest which had fallen due as was then capable of being capitalised under the* 1905 *deed. On 29th June,* 1938, *the life tenant under the settlement died and the reversion fell in, and L's trustees on 13th September,* 1938, *executed a further instrument of capitalisation of the interest as from 18th August,* 1938. *No calculation of the interest capitalised was made when either instrument was executed. Subsequently two calculations were made—one on a gross basis and one on a net basis after deduction of Income Tax—of the amount due to L's trustees, but the amount of the settlement funds was less even than the amount of the advances plus interest capitalised on a net basis (on which basis L's trustees made their claim), and early in* 1940 *the trustee of the settlement (the Respondent) handed over to L's trustees the whole of the funds remaining in his hands (less certain costs).*

The Respondent was assessed to Income Tax for the year 1939–40 *under General Rule* 21 *in respect of the difference between the aggregate of the original advances and the amount handed over by him to L's trustees, on the ground that the difference represented interest paid by or through him not out of profits or gains brought into charge, and that there had been no payment, actual or notional, on the occasion of either of the two instruments of capitalisation.*

On appeal to the Special Commissioners the Respondent contended that there had been no payment of interest by or through him within the meaning of General Rule 21, *and that on each occasion when interest was capitalised by L's trustees the effect was to add to the principal sums only the net amount of the interest after deduction of Income Tax. The Special Commissioners were unable to distinguish the case in any material respect from that of* Com-

(1) Reported (K.B.) [1943] 2 All E.R. 754; (C.A.) 170 L.T.289; (H.L.) [1945] A.C.360.

missioners of Inland Revenue *v.* Lawrence, Graham & Co., 21 T.C. 158, *and discharged the assessment.*

Held, (i) *that there was no payment of interest within the meaning of General Rule* 21 *by virtue of the two instruments of capitalisation of* 1935 *and* 1938, *and* (ii) *that the amount paid to L's trustees in* 1940 *over and above the original capital loans was a payment of interest from which tax was deductible under Rule* 21 *by the Respondent, who was the person " by or through " whom " the payment was made.*

Paton (as Fenton's Trustee) *v.* Commissioners of Inland Revenue, 21 T.C. 626, *applied*; Commissioners of Inland Revenue *v.* Lawrence, Graham & Co., 21 T.C. 158, *overruled.*

CASE

Stated under the Income Tax Act, 1918, Section 149, by the Commissioners for the Special Purposes of the Income Tax Acts for the opinion of the King's Bench Division of the High Court of Justice.

1. At a meeting of the Commissioners for the Special Purposes of the Income Tax Acts held on 9th March, 1942, Major K. A. Oswald, the sole surviving trustee of the Cosier settlement (hereinafter called " the Respondent "), appealed against an assessment to Income Tax for the year ended 5th April, 1940, in the sum of £6,500 made under the provisions of Rule 21 of the General Rules applicable to Schedules A, B, C, D and E of the Income Tax Act, 1918.

2. By a deed dated 21st April, 1899, Mrs. Elfrida Beyfus (hereinafter called " the borrower ") mortgaged her reversionary interest under a deed of settlement dated 8th June, 1885 (hereinafter referred to as " the Cosier settlement "), to Mrs. Emma Louise Liberty (hereinafter called " the mortgagee ") to secure the sum of £2,300 with interest at 5 per cent. per annum. A copy of this deed is annexed hereto, marked " A ", and forms part of this Case [1].

3. On 26th March, 1901, the borrower executed a further charge of the reversionary interest to the mortgagee to secure a further advance of £500 with interest at 5 per cent. per annum. A copy of this charge is annexed hereto, marked " B ", and forms part of this Case [1].

4. On 10th January, 1905, the borrower assigned to Jonas Wolfe, Abraham Wolfe and Alexander Wolfe the sum of £500 (part of her said reversionary interest) subject nevertheless to the mortgage of 21st April, 1899, and the further charge of 26th March, 1901.

5. On 18th May, 1905, the borrower executed a further charge of the reversionary interest to the mortgagee to secure a further advance of £300 (subject to the assignment of 10th January, 1905), and it was thereby provided that interest on the three sums of £2,300, £500 and £300 should thenceforth be paid at the rate of 5½ per cent. per annum subject to a proviso for the reduction of the rate to 5 per cent. per annum on punctual payment.

This further charge contained the following provision in regard to the capitalisation of interest :—

" And it is hereby further agreed and declared that all interest which " shall fall due on the said sums of £2,300 £500 and £300 whether by " virtue of the foregoing covenants or the covenants contained in the " hereinbefore recited Indentures and shall not be paid within 21 days " after the dates thereby and hereby appointed for payment thereof

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[1] Not included in the present print.

"may at the option of the Mortgagee be capitalised as from such last "mentioned appointed date and be added to the principal moneys hereby "secured so as to form one aggregate sum charged on the property hereby "mortgaged and carrying interest at the rate aforesaid and the Mortgagor "doth hereby covenant with the Mortgagee to pay to the Mortgagee "the interest on such capitalised interest at the rate aforesaid on the "aforesaid days thereinbefore and herein appointed for payment of "interest and nothing in this proviso contained shall prevent the Mortgagee "notwithstanding the capitalisation of the interest from subsequently "exercising all the rights powers and privileges of a Mortgagee as if the "interest had not been paid or capitalised and it shall be lawful for the "Mortgagee to treat a portion of the interest as capitalised and a portion "as if no option as aforesaid had been expressed by the Mortgagee". A copy of this further charge is annexed hereto, marked "C", and forms part of this Case (1).

6. No interest was paid on the advances after 18th August, 1906, except in the manner and to the extent hereinafter stated.

7. On 2nd May, 1920, the mortgagee (then Lady (Emma Louise) Liberty) died and her will and codicils were duly proved on 22nd July, 1920, in the Principal Probate Registry by Messrs. H. C. Blackmore and E. C. Francis, the surviving executors named therein.

8. The borrower died on 11th January, 1933, and no representation has been taken out to her estate.

9. On 9th August, 1935, Messrs. H. C. Blackmore and V. W. G. Ranger (who were the then trustees of Lady Liberty's will and are hereinafter called "Lady Liberty's trustees") executed an instrument under which they capitalised as from 18th May, 1935, so much of the interest fallen due on the said principal sums of £2,300, £500 and £300 as was then capable of being capitalised by virtue of the provisions contained in the further charge of 18th May, 1905. A copy of this instrument is annexed hereto, marked "D", and forms part of this Case (1).

10. On 29th June, 1938, the borrower's reversionary interest under the Cosier settlement fell into possession on the death on that date of the tenant for life, the Hon. Hyacinth Jacqueline Blanche Ormond Hay (formerly Farrer then Cosier then Poyser).

11. On 13th September, 1938, Lady Liberty's trustees executed a further instrument of capitalisation under which they capitalised as from 18th August, 1938, so much of the interest fallen due on (*a*) the said principal sums of £2,300, £500 and £300 and on (*b*) the interest thereon previously capitalised as was then capable of being capitalised by virtue of the provisions contained in the said further charge of 18th May, 1905. A copy of this instrument is annexed hereto, marked "E", and forms part of this Case (1).

12. No accounts or calculations of the interest capitalised were prepared when either of the instruments of capitalisation dated 9th August, 1935, and 13th September, 1938 (exhibits "D" and "E") was executed, nor was there on either occasion any correspondence on the subject between the parties.

13. Following the death of the tenant for life negotiations took place between Lady Liberty's trustees and the trustees of the Cosier settlement (hereinafter referred to as "the Cosier trustees"), under which the reversionary interest was derived, which resulted in an agreement the terms of which were

(1) Not included in the present print.

embodied in heads of agreement dated 20th July, 1939, made between the Cosier trustees (of whom the Respondent was one) of the one part and Lady Liberty's trustees of the other part. A copy of the heads of agreement is annexed hereto, marked " F ", and forms part of this Case (1).

14. Pursuant to that agreement the sum of £500 due to the said Jonas Wolfe, Abraham Wolfe and Alexander Wolfe (but without interest) was raised out of the trust fund and paid to them, and on 15th September, 1939, a reassignment in favour of the Cosier trustees was duly executed by them.

15. On various dates in January and February, 1940, the Cosier trustees, in pursuance of the said agreement, handed over to the Liberty trustees all the funds (both capital and income) then remaining in their hands, which consisted of :—

(*a*) Securities of an agreed value of	£7,438	12	5
(*b*) Cash representing income (most of which has been taxed by deduction at the source)	£166	6	6
	£7,604	18	11

Pursuant to the said agreement this £7,604 18*s.* 11*d.* was appropriated as follows, viz. :—

(1) To costs of the Liberty trustees	£105	15	10
(2) To repayment of the principal sums of £2,300, £500 and £300	£3,100	0	0
(3) To interest thereon (including capitalised interest) ..	£4,399	3	1
	£7,604	18	11

A copy of the valuation statement relating to the said securities is annexed hereto, marked " G ", and forms part of this Case (1).

16. The fund now stands as to half in the names of Lady Liberty's trustees and as to the remaining half in the joint names of Lady Liberty's trustees and the Cosier trustees.

17. There are also annexed hereto two calculations of principal and interest, viz., (1) a calculation on a gross capitalisation of interest basis, showing a total sum of £9,462 3*s.* 11*d.* ; (2) a calculation on a net capitalisation of interest basis, showing a total sum of £8,301 8*s.* 2*d.*

It is agreed between the parties that :—

(*a*) the first named calculation was prepared on behalf of the Liberty trustees merely for the purpose of showing the maximum possible claim they might have against the Cosier trustees if no account were taken of the tax position, and that the same was not in fact acted upon ;

(*b*) the second mentioned calculation shows the calculation of the sum of £8,301 8*s.* 2*d.* mentioned in recital (3) of the above-mentioned heads of agreement of 20th July, 1939 ;

(*c*) both of the said calculations are merely annexed as illustrative of the figures according to whether the capitalisation of the interest was on a gross or a net basis, and they are so annexed without prejudice to the contentions of either party to the appeal.

These calculations are annexed hereto, marked " H " and " I ", respectively, and form part of this Case (1).

(1) Not included in the present print.

18. It was contended on behalf of the Respondent :—

(*a*) That there had been no payment of interest by or through the Cosier trustees within the meaning of the said Rule 21.

(*b*) That on each occasion when interest was capitalised by Lady Liberty's trustees the effect of such capitalisation was to add to the principal sums only the net amount of the interest after deduction of Income Tax.

(*c*) That the Cosier trustees were not accountable under the said Rule 21 for the tax deducted upon the capitalisation of the interest by Lady Liberty's trustees.

The case of *Commissioners of Inland Revenue* v. *Lawrence, Graham & Co.*, 21 T.C. 158, was referred to.

19. It was contended on behalf of the Appellants :—

(1) That the Cosier trustees were persons by or through whom, during the year 1939–40, interest to the amount of £4,399 3*s*. 1*d*. had been paid within the meaning of the said Rule 21.

(2) That there had been no payment either actual or notional of interest on the occasion of either of the two instruments of capitalisation (exhibits " D " and " E ").

(3) That the Cosier trustees were accountable under the said Rule 21 for the Income Tax chargeable in respect of the said interest amounting to £4,399 3*s*. 1*d*. paid to Lady Liberty's trustees in the year 1939–40.

(4) That the case of *Commissioners of Inland Revenue* v. *Lawrence, Graham & Co.*, 21 T.C. 158, was distinguishable.

(5) That the assessment was correct in principle and, subject to being reduced to the proper amount, should be confirmed.

20. We, the Commissioners, were unable to distinguish the present case in any material respect from the case of *Commissioners of Inland Revenue* v. *Lawrence, Graham & Co.*, 21 T.C. 158. We allowed the appeal and discharged the assessment.

21. The representative of the Appellants immediately after the determination of the appeal declared to us his dissatisfaction therewith as being erroneous in point of law and in due course required us to state a Case for the opinion of the High Court pursuant to the Income Tax Act, 1918, Section 149, which Case we have stated and do sign accordingly.

R. COKE,
MARK GRANT-STURGIS, } Commissioners for the Special Purposes of the Income Tax Acts.

Turnstile House,
94/99 High Holborn,
London, W.C.1.

2nd December, 1942.

The case came before Macnaghten, J., in the King's Bench Division on 21st, 22nd and 25th October, 1943, and on the last-named date judgment was given against the Crown, with costs.

The Attorney-General (Sir Donald Somervell, K.C.) and Mr. Reginald P. Hills appeared as Counsel for the Crown, and Mr. J. Millard Tucker, K.C., and Mr. J. S. Scrimgeour for the Respondent.

JUDGMENT

Macnaghten, J.—This is an appeal by the Commissioners of Inland Revenue from a decision of the Special Commissioners discharging an assessment to Income Tax for the year 1939–40 made upon the Respondent, Major K. A. Oswald, D.S.O., under Rule 21 of the General Rules applicable to all Schedules.

The Respondent is the sole surviving trustee of a settlement dated 8th June, 1885, made on the marriage of a Mr. R. W. Cosier to a Miss Farrer, whereby the sum of £10,000 was settled on the spouses and the issue of the marriage. Mr. R. W. Cosier died on 23rd June, 1894, and under the provisions of his will a Mrs. Elfrida Beyfus became entitled, in the events that happened, to the funds comprised in the settlement, subject to the life interest of his widow. Mrs. Beyfus subsequently executed the following charges on her reversionary interest under the settlement. By deeds dated 21st April, 1899, and 26th March, 1901, she mortgaged her reversionary interest to a Mrs. Liberty to secure the repayment of the sums of £2,300 and £500 with interest thereon at 5 per cent. per annum. On 10th January, 1905, she assigned to Jonas Wolfe, Abraham Wolfe and Alexander Wolfe £500, part of her reversionary interest, subject to the charges previously created in favour of Mrs. Liberty, and by a deed dated 18th May, 1905, she executed a further charge in favour of Mrs. Liberty to secure a further advance of £300. By that deed it was provided that the interest on the sums of £2,300 and £500, as well as the £300, should thenceforth be at the rate of 5½ per cent. per annum payable quarterly on 18th February, 18th May, 18th August and 18th November, reducible, however, to 5 per cent. if payment were made within twenty-one days of the due date. The deed further provided that, if the interest were not paid within twenty-one days after it became due, it might at the option of the mortgagee be capitalised as from the date when it became due. No interest was paid by Mrs. Beyfus after 18th August, 1906. She died on 11th January, 1933, and no representation has been taken out to her estate. On 2nd May, 1920, Mrs. Liberty, then Lady Liberty, died. Her will was duly proved by the executors named therein. On 29th June, 1938, the widow of Mr. R. W. Cosier died, and Mrs. Beyfus's reversionary interest fell into possession. The fund in the hands of the Respondent as the sole surviving trustee of the settlement was amply sufficient to pay the £500 due to the Messrs. Wolfe and the sums of £2,300, £500 and £300 advanced by Lady Liberty, and in these circumstances the assessment in question was made upon the balance remaining after payment of those principal sums on the footing that it was payable to the Liberty trustees in respect of arrears of interest and therefore assessable to Income Tax.

By an instrument dated 9th August, 1935, the trustees of Lady Liberty's will exercised the option given by the deed dated 18th May, 1905, and capitalised as from 18th May, 1935, " so much of the interest fallen due on " the principal sums of £2,300 £500 and £300 . . . as is now capable of " being capitalised by virtue of the provisions " contained in that deed, and by another instrument dated 13th September, 1938, they capitalised as from 18th August, 1938, the interest that had fallen due since 18th May, 1935. The interest so capitalised and the principal sums of £2,300, £500 and £300 together amounted to £8,301 8*s.* 2*d.*, and the Liberty trustees made claim to that amount as the capital sum due to them under the charges created in favour of their testatrix. The Special Commissioners held that that claim was well founded, and discharged the assessment. They were of the opinion that the present case could not be distinguished in any material respect from the case of the *Commissioners of Inland Revenue* v. *Lawrence, Graham & Co.*, 21 T.C. 158.

(Macnaghten, J.)

In that case the Legal & General Assurance Society had advanced a sum of £10,000 on the security of certain reversionary interests, and the borrower had agreed to pay interest on the advance at such a rate per cent. per annum (varying with the rate for the time being of Income Tax) that after deduction of Income Tax from each periodical payment of interest there would remain a net sum equivalent to interest at 5½ per cent. per annum, reducible to 4½ per cent. per annum on punctual payment. The borrower failed to pay any interest, and the society, exercising rights conferred upon them by the mortgage deed, sold the reversionary interests. The price paid for those interests was received by Messrs. Lawrence, Graham & Co., the society's solicitors, and was more than sufficient to pay all that was due to the society. Messrs. Lawrence, Graham & Co. paid the amount of the advance and the capitalised interest to their clients and then paid the balance to a second mortgagee of the reversionary interests. The Commissioners of Inland Revenue made an assessment under Rule 21 of the General Rules upon Messrs. Lawrence, Graham & Co. on the footing that the provisions in the deed for the capitalisation of interest payable to the society could not deprive the Crown of the right to Income Tax on the interest so capitalised. The case was taken to the Court of Appeal, and the judgment of the Court (consisting of Lord Wright, M.R., and Romer and Greene, L.JJ.) was delivered by Romer, L.J. He pointed out that under the covenant in that case the power to capitalise unpaid interest was limited to the net interest, meaning by that expression the amount of the interest payable to the society after deducting the tax payable thereon(1). The case therefore established that a covenant conferring upon the mortgagee the right to capitalise the net interest is valid, and by the exercise of that right the net interest is converted into principal money, and is not assessable to Income Tax under Rule 21.

The Attorney-General contended that the present case differs from the case of *Lawrence, Graham & Co.* in that the deed of 18th May, 1905, did not provide that the unpaid interest should be accumulated willy-nilly; it merely gave the mortgagee an option to capitalise it; but I do not think that is a distinction that makes any difference for the present purpose.

The other suggested distinction between the two cases is that, whereas in the *Lawrence, Graham* case the interest to be capitalised was the net interest, the covenant in this case provided for the capitalisation of " the " interest ", an expression which might mean either the gross interest or the net interest. The Liberty trustees purported to capitalise " so much of the " interest fallen due on the principal sums as is now capable of being " capitalised ", and their claim of £8,301 8*s.* 2*d.* was made up by capitalisation of the net interest.

In those circumstances it seems to me that the Special Commissioners were right in saying that the present case cannot be distinguished from the case of *Lawrence, Graham & Co.* I think, therefore, that the appeal must be dismissed with costs.

The Crown having appealed against the decision in the King's Bench Division, the case came before the Court of Appeal (Lord Greene, M.R., and Mackinnon and Luxmoore, L.JJ.) on 14th, 15th and 16th March, 1944, and on the last-named date judgment was given unanimously against the Crown, with costs, confirming the decision of the Court below.

The Attorney-General (Sir Donald Somervell, K.C.), Mr. J. H. Stamp and Mr. Reginald P. Hills appeared as Counsel for the Crown, and Mr. J. Millard Tucker, K.C., and Mr. J. S. Scrimgeour for the Respondent.

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(1) 21 T.C., at p. 176.

JUDGMENT

Lord Greene, M.R.—This appeal deals with one of the most troublesome questions that from time to time falls to be considered under the Income Tax Acts, namely, the application of those Acts to cases of mortgages which provide for the capitalisation of interest in arrear.

The Respondent, against whom the assessment in question was made, is the sole surviving trustee of a settlement. Under that settlement a Mrs. Beyfus, whom I will call the mortgagor, was entitled to a reversionary interest. She mortgaged her interest by three successive instruments, a mortgage and two instruments of further charge. There was also another transaction with some gentlemen of the name of Wolfe, which I propose to ignore, as it has nothing to do with this case.

The second of the two further charges, which was dated 18th May, 1905, contained a special clause which applied both to the original mortgage, the first further charge and the second further charge, providing for capitalisation of unpaid interest at the option of the mortgagee. The precise language of that clause I shall have to examine in a moment. The mortgagees exercised the power of capitalisation on two occasions, the first being on 9th August, 1935, and the second on 13th September, 1938, the arrears of interest being very large.

The mortgagor died on 11th January, 1933. No representation has ever been taken out to her estate, and it is not too much to suppose that she died possessed of no assets of any value. That circumstance explains why it is that this particular controversy has arisen, as will become clearer in a moment.

On 29th June, 1938, the reversion fell into possession on the death of the tenant for life under the settlement. The trust fund, including cash, amounted in value to £7,600. The principal sums secured by the mortgage and the two instruments of further charge amounted to £3,100, with the result that, after discharging certain costs, there was a sum of £4,399 over and above the principal amounts secured. That £4,399, excluding whatever part of it may have been attributable to current interest, as distinct from capitalised interest, was in point of fact in amount far below the arrears of the net interest payable under these hypothecations, that is to say, the interest after deduction of tax.

The footing upon which the Crown's claim is made is that the trustee of the settlement, namely, the present Respondent, is assessable to tax in respect of interest under Rule 21 of the General Rules as being the person "by or "through whom" a payment of interest is made. We are proceeding on the footing that the trustee has handed over to the mortgagees the whole of the proceeds of the reversionary interest. The assessment is made on the footing that, under Rule 21, the trustee, on handing over so much of the proceeds as did not represent the original capital, was bound to deduct tax at the proper rate, and account for it to the Revenue on the basis that interest could not be said to have been paid (as on the facts before us it clearly could not be said to have been paid) out of income brought into charge to tax. That was the nature of the assessment.

It was said, in support of that, that when this money was handed over by the trustee to the mortgagees, that constituted a payment of interest at the date when it was handed over, and that, accordingly, the trustee, in making that payment, ought to have deducted tax at the rate in force at the time of payment—that is the language of Rule 21 (1)—and accounted for it to the Revenue.

(Lord Greene, M.R.)

The Special Commissioners, whose decision was affirmed by Macnaghten, J., discharged the assessment on the ground that the present case was covered by the decision of this Court in *Commissioners of Inland Revenue* v. *Lawrence, Graham & Co.*, 21 T.C. 158. In the course of the argument before us a considerable discussion ranged round that decision, and it was suggested at one time that it ought not to be regarded any longer as being law, the suggestion being that, in some way, the principles on which it was decided were inconsistent with the reasoning of the House of Lords in the later case of *Paton (as Fenton's Trustee)* v. *Commissioners of Inland Revenue*, 21 T.C. 626. I do not think it necessary or right for us in this Court to deal in any way with what has been said with regard to the case of *Lawrence, Graham & Co.*, nor can I possibly treat it as having been impliedly overruled by the *Paton* case. The decision in *Paton's* case was on a different matter. Different reasoning applied to it. In my opinion, the decision in the *Lawrence, Graham* case is a decision which is binding upon this Court and which, accordingly, the Court will follow.

In order to appreciate its application to the present case, it is worth while indicating what, for present purposes, appears to be the principle to be extracted from the case of *Lawrence, Graham*. It is always dangerous to paraphrase the language of another judgment, but I have already, in an earlier case, given an opinion as to the gist of the decision. I think on the present occasion, as the approach is rather different, no harm will be done if I indicate what seem to me to be the relevant propositions to be extracted from the *Lawrence, Graham* case. That case, like the present, was a case in which the Crown was claiming tax from an intermediary. The intermediary was a firm of solicitors who had dealt with the funds in question, and it was a claim as against them that there had been a payment of interest by or through them. Accordingly, it was said they were under a statutory obligation to deduct tax and, in the circumstances, to account for it to the Revenue. They escaped liability on the ground that the sum which had passed through their hands was a sum from which tax had already been deducted.

Rule 21, when it gives power to assess an intermediary, obviously does not enable an assessment to be made against the intermediary through whose hands nothing but a net sum has passed. In such a case the Crown must enforce its rights against the person whom, for convenience, I will call the principal, that is to say, the mortgagor or the borrower. If the mortgagor has deducted tax and has handed the net amount to his intermediary and the intermediary pays that net amount over to the mortgagee, there can be no liability or accountability on the intermediary. On the other hand, the mortgagor who has deducted the tax is accountable under Rule 21, assuming it is a Rule 21 case, and not a case where, under Rule 19, he is entitled to retain tax. The effect of the decision in the *Lawrence, Graham* case, therefore, was that the solicitors, who were intermediaries there, having handled what was nothing more than a net sum, could not lawfully be assessed. As I say, that does not mean that the Crown loses its tax except by the fortuitous and irrelevant circumstances of the insolvency of the mortgagor.

That is where the shoe pinches in this case, because if, as in the *Lawrence, Graham* case, tax is to be treated as having been deducted on the occasion of the capitalisation, then the trustee, in handing over in satisfaction of the mortgage obligations of the mortgagor the proceeds of this reversionary interest, cannot be treated, as between himself and the Revenue, as having paid away a gross sum. If that view be right, the result would be that the Crown could not attack the trustee. The person whom they would have to

(Lord Greene, M.R.)

attack would be the mortgagor herself, who, by virtue of the provision in the deed, would be treated under the *Lawrence, Graham*(1) principle as having deducted tax on the occasion of the capitalisation. But the mortgagor's estate being, in the present case, quite obviously insolvent, if the Crown cannot succeed in raising an effective assessment against the trustee it will lose its tax. That is a misfortune, if that be the result, due entirely to the fact that the mortgagor's estate is insolvent.

In the *Lawrence, Graham* case it was pointed out that there is nothing to prevent a debtor agreeing with his creditor, when the occasion for payment of interest arrives, to satisfy his net interest obligation, that is to say, the interest less tax, by some means other than cash payment—for instance, by the assignment of a chattel. In that case, what was equivalent, in the view of the Court, to the assignment of the chattel was the capitalisation of the net interest which was unpaid. But, on the occasion of that capitalisation, the subject-matter of capitalisation being the amount of the net interest, the mortgagor must be treated as having deducted the tax which, under Rule 21, he was bound to deduct, and remained, accordingly, accountable to the Revenue. The relevant passage, 21 T.C., at page 175, is in the following terms: " If " instead of paying the full amount of the interest the debtor pays to his " creditor the interest less the tax, he has fulfilled his obligation, even though " the payment exhausts his cash in hand or, if paid by cheque, leaves " nothing standing to his credit at his bankers. So long as the net interest " and no more reaches the hands of the creditor the Crown has no cause for " complaint. Nor can the Crown be concerned with the form in which the " net interest reaches the hands of the creditor. The creditor may, if he " thinks fit, agree to accept in full satisfaction of the net amount a bill or a " bond or a chattel provided that the money value of what he gets in exchange " does not exceed the net interest due. If this be so, a mortgagor and a " mortgagee may validly agree that, in the event of failure by the mortgagor " to pay the net interest as it falls due, the mortgagee will from time to time " accept, in full discharge of the mortgagor's liability to pay it, a capital " charge for a like amount upon the mortgaged security. As and when each " charge takes effect the tax will have been deducted within the meaning " of the Rule, for the capital charge merely takes the place of a payment by " the mortgagor of the net amount and can never exceed that net amount in " money value."

In that passage the Court, in the judgment read by Romer, L.J., is putting the substitution of a new capital liability for the interest liability on the same footing as a satisfaction of net interest by, for instance, the assignment of a chattel. As between mortgagor and mortgagee that is the position. The Court is also saying, as I read it, that, as between those parties and the Crown, the position is that deduction has been made on the occasion of capitalisation and the person who makes the deduction is the mortgagor, who is, accordingly, accountable. Accepting that principle fully, and applying it to the present case, it seems to me that the only question we have to decide is whether the principles laid down in that case are applicable to the particular document which we have before us. If they are, the Crown's claim must fail.

The argument for the Crown on that point was of this nature. It was said, and truly said, that in the *Lawrence, Graham* case the relevant document was construed by this Court as being a contract between the mortgagor and the mortgagee under which the sum to be capitalised, on any occasion when capitalisation took effect, was the net interest liability of the mortgagor; in other words, that capitalisation was to be the capitalisation of the net and not

(1) 21 T.C. 158.

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the gross interest. If, on its true construction, the relevant clause in this case provides similarly for capitalisation of the net interest and not the gross interest, then the decision in the *Lawrence, Graham* case(1) is admittedly precisely in point.

I propose, first of all, to examine shortly the relevant provisions of this particular clause. By way of preface, I may call attention to two matters. First, it seems to me that the whole conception of an agreement for the capitalisation of the gross amount of interest is one which, in its nature, would be very remarkable and, I should have thought, most unlikely. Capitalisation, it must be remembered, includes two elements in its normal use. One is what I may call the interest element, namely, the fact that something which previously had not borne interest should now produce interest. That is a plain interest element. The other element is that what was originally an obligation to pay interest is turned into an obligation to pay capital as between the mortgagor and the mortgagee.

It does seem to me highly improbable that a mortgagee, when stipulating for capitalisation, should stipulate for a provision under which he would be entitled to interest on a sum which he never could receive; that is to say, that portion of the interest amount which the mortgagor is entitled to deduct when paying interest. An example will make this clear. If you have a mortgage carrying interest at 6 per cent. and the rate of tax is, let us say, for the sake of simplicity, 10*s*., the mortgagor can satisfy that liability by paying £3, and the mortgagee, when he has got it, can invest that £3 and earn interest upon it. If capitalisation is limited to the net amount, namely £3, it is on £3 and no more that interest would be received by the mortgagee in future. If, on the other hand, the capitalisation is what for brevity we have called a gross capitalisation, the mortgagee thereafter will be receiving from the mortgagor interest not on £3, which is the sum he would have received if the interest had been paid, but on £6, a sum which he never would have received. Why it should enter the head of a mortgagee to stipulate for a benefit of that kind I do not understand.

The next point is this. If the agreement for capitalisation means that the sum to be capitalised is the gross interest and not the net interest, I cannot for myself see what sort of benefit the mortgagee is going to gain by insisting on gross rather than net capitalisation, because I share the difficulty of Counsel for the Crown in seeing how it could be said that the mortgagor and mortgagee, by stipulating for a gross capitalisation, can defeat the Crown's claim for tax. Therefore, it would follow that, when the payment of this alleged gross sum comes to be made, the payer would deduct tax from it. What good, therefore, would the lender have done to himself by insisting upon a capitalisation of the gross sum rather than a capitalisation of the net sum? Those are merely improbabilities and cannot affect the construction of this language, if the words mean what the Crown says they mean. But I think it is legitimate to bear those matters in mind in considering the exact language which the parties have used.

So far as relevant, the capitalisation clause is as follows: " And it is " hereby further agreed and declared that all interest which shall fall due " on the said principal sums " and shall not be paid within 21 days after " the dates thereby and hereby appointed for payment thereof may at the " option of the Mortgagee be capitalised ". I pause there for a moment. It is perfectly true that the liability of a mortgagor is in law a liability to pay the gross amount of the interest. But he is equally in law entitled to discharge that liability and free himself from it by paying that amount less tax.

(1) 21 T.C. 158.

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Accordingly, what comes to the hand of the mortgagee must always be the net amount unless the mortgagor, under a case falling under Rule 19, is of so benevolent a disposition that he does not exercise his right to deduct, a possibility, human nature being what it is, that can well be disregarded. When, therefore, this clause uses the phrase " all interest which shall fall " due . . . and shall not be paid ", it seems to me that it is contemplating the precise cash transaction which, normally, on the due date of the interest falling due, would take place between mortgagor and mortgagee, namely, payment. That transaction would be a payment in cash of the net amount and not a payment of the gross amount; therefore, it seems to me that that language, by itself, is sufficient to show that this is dealing with what one would expect the parties to deal with, a capitalisation of the net amount and nothing more.

It seems to me that later on in the clause there are words which strengthen that conclusion, because at the end these words follow, " and nothing in this " proviso contained shall prevent the Mortgagee notwithstanding the capitalisa- " tion of the interest from subsequently exercising all the rights powers " and privileges of the Mortgagee as if the interest had not been paid or " capitalised ". What would have been the position of the mortgagee if the capitalisation had not taken place? His right, and his only right, would have been to obtain from the mortgagor the net amount of interest—nothing more. It appears to be improbable that that sentence would have been penned if the rights after capitalisation related to a sum arrived at on a totally different basis from the basis on which the sum to be paid would have been arrived at if it had been paid.

The clause then goes on: " and it shall be lawful for the Mortgagee to " treat a portion of the interest as capitalised and a portion as if no option " as aforesaid had been expressed by the Mortgagee ". That is contemplating that the result of the mortgagee's action may be that there will be at some time and for some purposes a portion capitalised and a portion not capitalised. It seems to me it would be very extraordinary to have a position where there would be two portions of interest, one of them a capitalised portion on a gross basis, and one an uncapitalised portion effectively on a net basis. Those words seem to me to confirm the view which I have already expressed, which I think is to be extracted from the opening words; and the general result appears to me to be sensible and in accordance with what would be expected from reasonable persons.

Therefore, looking at the mere construction of the document, it seems to me that it is one which provides for the capitalisation of net interest. It follows, if that view be right, on the *Lawrence, Graham*(1) principle, that neither the trustee nor the mortgagee handled anything more than the net sum, and the only person liable to the Crown is the mortgagor, who, by the operation of the bargain which she made, has to be treated as having deducted tax on the occasions of the capitalisation.

But it is said that the decision in the *Lawrence, Graham* case depended on the presence there of the expression " the sum due ". The phrase there was this: " the sum due in respect of the half-year's interest so unpaid shall be " converted into and become principal money ". It is contended that the whole decision turned on the presence of the words " the sum due " as distinct from the words " the interest ". It is perfectly true that Romer, L.J., in delivering the judgment of the Court, laid emphasis on that difference in language; but he quite clearly did so as fortifying and reinforcing his general conclusion(2). I am quite unable to accept the suggestion that his reference

(1) 21 T.C. 158. (2) *Ibid.*, at p. 176.

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to that particular phraseology formed the real basis of the decision. That reference was introduced by the words, " In this connection it is to be " noticed ", a form of words which is very commonly used by learned Judges when they are bringing in an additional argument which reinforces the main one; certainly not a formula such as one finds when the Court is describing what, in its view, are the real gist and basis of its decision.

It seems to me, so far as the question of construction is concerned, all that can be extracted from the *Lawrence, Graham* case(1) is that if, on the true construction of a deed of mortgage, or whatever the document may be, the provision for capitalisation is a provision for capitalisation of the net amount, then the legal consequences indicated in the judgment would follow. But it must turn on the construction of the individual instrument. The presence or absence of any particular phrase, important though it may be, cannot by itself be decisive, because you have to read each particular instrument as a whole and ascertain what it means. On that basis, having done my best to construe the clause in this way, I think it should be construed in the way which I have mentioned, which, as I say, is consistent with good sense and business.

In the result, therefore, I think both the Commissioners and Macnaghten, J., were right in thinking that this case is covered by the decision of this Court in the *Lawrence, Graham* case, and that this appeal must be dismissed.

MacKinnon, L.J.—I agree.

Luxmoore, L.J.—I also agree.

The Attorney-General.—I think we should have an acknowledgment as to the position as to the costs. You will take an Order: Appeal dismissed with costs. Does that suit you, Mr. Tucker?

Mr. Tucker.—That is enough.

The Attorney-General.—I would ask for leave to appeal.

Lord Greene, M.R.—What do you say, Mr. Tucker?

The Attorney-General.—It will be on terms—such terms as my friend knows about.

Lord Greene, M.R.—The same terms?

Mr. Tucker.—I think we can get a little better terms.

The Attorney-General.—You may get better terms.

Mr. Tucker.—I do not wish to oppose the application because we have known all along that we have been brought here really for the assistance of the Crown rather than on any question in which we have any pecuniary interest ourselves whatever.

Lord Greene, M.R.—We need not say anything about the terms in giving leave—that is an arrangement between you?

Mr. Tucker.—Yes.

Lord Greene, M.R.—Then we simply give leave to appeal. You can have leave, Mr. Attorney.

The Attorney-General.—I am much obliged.

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(1) 21 T.C. 158.

Lord Greene, M.R.—Do you want any Order for costs?

Mr. Tucker.—I ought to take a formal Order, I think.

The Attorney-General.—My friend will take a formal Order for costs.

Mr. Tucker.—Perhaps your Lordships would say that the appeal is dismissed with costs.

Lord Greene, M.R.—Yes.

The Attorney-General.—I think that perhaps satisfies the position.

The Crown having appealed against the decision in the Court of Appeal, the case came before the House of Lords (Lords Thankerton, Russell of Killowen, Macmillan, Porter and Simonds) on 12th, 13th and 14th March, 1945, when judgment was reserved. On 19th April, 1945, judgment was given unanimously in favour of the Crown, reversing the decision of the Court below.

The Attorney-General (Sir Donald Somervell, K.C.), Mr. J. H. Stamp and Mr. Reginald P. Hills appeared as Counsel for the Crown, and Mr. J. Millard Tucker, K.C., and Mr. J. S. Scrimgeour for the Respondent.

JUDGMENT

Lord Thankerton (read by Lord Macmillan).—My Lords, this appeal arises on a Case stated by the Special Commissioners who had discharged an assessment to Income Tax for the year ended 5th April, 1940, on the Respondent, as sole surviving trustee of the Cosier settlement, in the sum of £6,500, made under Rule 21 of the General Rules applicable to Schedules A, B, C, D and E of the Income Tax Act, 1918. The decision of the Special Commissioners has been affirmed in both Courts below.

While the facts are fully set out in the Case, and the relevant documents are printed in the appendix thereto, the facts material to the decision of this appeal may be stated as follows. In 1899 Mrs. Elfrida Beyfus (who may be referred to as "the borrower") mortgaged a reversionary interest to which she was entitled under a deed of settlement dated 8th June, 1885 (which may be referred to as "the Cosier settlement") to Mrs. Emma Louise Liberty (who may be referred to as "the mortgagee") to secure the sum of £2,300 with interest at 5 per cent. per annum. In 1901 the borrower further charged her reversionary interest to the mortgagee to secure a further advance of £500 with interest at 5 per cent. In 1905 the borrower assigned to Jonas Wolfe and certain other parties the sum of £500, part of her reversionary interest, but subject to the mortgages of 1899 and 1901.

On 18th May, 1905, the borrower executed a further charge of her reversionary interest to the mortgagee to secure a further advance of £300, and it was thereby provided that interest on the three sums of £2,300, £500 and £300 should thenceforth be paid at the rate of 5½ per cent., subject to a proviso for the reduction of the rate to 5 per cent. on punctual payment. This further charge contained the following provision: "And it is hereby further agreed "and declared that all interest which shall fall due on the said sums of £2,300 "£500 and £300 whether by virtue of the foregoing covenants or the covenants "contained in the hereinbefore recited Indentures and shall not be paid within "21 days after [the dates thereby and hereby appointed for payment

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" thereof may at the option of the Mortgagee be capitalised as from such last " mentioned appointed date and be added to the principal moneys hereby " secured so as to form one aggregate sum charged on the property hereby " mortgaged and carrying interest at the rate aforesaid And the Mortgagor " doth hereby covenant with the Mortgagee to pay to the Mortgagee the " interest on such capitalised interest at the rate aforesaid on the aforesaid " days thereinbefore and herein appointed for payment of interest and nothing " in this proviso contained shall prevent the Mortgagee notwithstanding the " capitalisation of the interest from subsequently exercising all the rights " powers and privileges of a Mortgagee as if the interest had not been paid " or capitalised and it shall be lawful for the Mortgagee to treat a portion of " the interest as capitalised and a portion as if no option as aforesaid had been " expressed by the Mortgagee". Interest was paid on the advances up to 18th August, 1906, but after that date no interest was paid, at least up to 9th August, 1935.

The mortgagee died on 2nd May, 1920, and the borrower died on 11th January, 1933. No representation was taken out to the borrower's estate; but the will and codicils of the mortgagee were duly proved by the surviving executors nominate. On 9th August, 1935, Messrs. H. C. Blackmore and V. W. G. Ranger, who may be referred to as Lady Liberty's trustees, executed an instrument whereby, in exercise of the power conferred by the indenture of further charge dated 18th May, 1905, they capitalised as from 18th May, 1935, so much of the interest fallen due on the principal sums of £2,300, £500 and £300 as was then capable of being capitalised and added the interest so capitalised to the principal sums so as to form one aggregate sum charged on the property mortgaged by the said indenture of further charge and carrying interest at the rate thereby provided. On 29th June, 1938, the borrower's reversionary interest under the Cosier settlement fell into possession. On 13th September, 1938, Lady Liberty's trustees executed a further instrument under which they capitalised in similar terms as from 18th August, 1938, so much of the interest fallen due on (*a*) the principal sums of £2,300, £500 and £300, and (*b*) the interest previously capitalised as was then capable of being capitalised by virtue of the provisions of the further charge dated 18th May, 1905.

Following negotiations, an agreement was arrived at and was embodied in heads of agreement dated 20th July, 1939, between Lady Liberty's trustees and the Cosier trustees, of whom the Respondent was one. It will be necessary to refer to the provisions of these heads of agreement in relation to a minor contention of the Respondent.

The main question is whether, by virtue of the two instruments dated 9th August, 1935, and 13th September, 1938, whereby the Liberty trustees exercised the option conferred by the indenture of further charge dated 18th May, 1905, the unpaid interest so capitalised was paid within the meaning of Rule 21 of the General Rules applicable to all Schedules, the material part of which provides as follows: " 21.—(1) Upon payment of any interest of " money, annuity, or other annual payment charged with tax under Schedule D, " or of any royalty or other sum paid in respect of the user of a patent, not " payable, or not wholly payable out of profits or gains brought into charge, " the person by or through whom any such payment is made shall deduct " thereout a sum representing the amount of the tax thereon at the rate of " tax in force at the time of the payment."

The Special Commissioners, Macnaghten, J., and the Court of Appeal have all held that the present case is ruled by the decision of the Court of Appeal in *Commissioners of Inland Revenue* v. *Lawrence, Graham & Co.*, [1937] 2 K.B.

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179; 21 T.C. 158, which has not been previously considered by this House. The Crown challenges the correctness of that decision, and I shall now deal with it. That case related to a mortgage and two further charges on the security of a reversionary interest; the mortgage contained a provision for the automatic conversion of unpaid half-yearly interest into principal money, carrying interest. Except that the clause operated automatically instead of resting on the optional exercise of a power, as in the present case, I find no material difference between the cases as regards the present question, nor can I see that that difference affects the decision of the present question. In both cases the Court of Appeal considered on construction whether the sum to be capitalised was the gross amount of interest or the net sum—that is, after deduction of Income Tax—and in both cases the Court of Appeal has held that it was the net sum. But, my Lords, it seems to me, with all respect to the learned Judges, to be idle to consider that question until and unless you have found that there was a payment of interest within the meaning of Rule 21 at the time of the capitalisation, as otherwise you cannot find "the amount "of the tax thereon at the rate of tax in force at the time of the payment." In *Lawrence, Graham & Co.'s* case the judgment of the Court (Lord Wright, M.R., Romer and Greene, L.JJ.) was delivered by Romer, L.J., and it will suffice to quote one passage from the judgment, [1937] 2 K.B., at page 195; 21 T.C., at page 175: "Turning once more to the rule it will be seen that it imposes "on every such person an obligation to deduct out of the interest a sum repre- "senting the tax thereon. It is plain that this does not necessitate the actual "setting aside of cash to meet the tax. A deduction in account is sufficient. "If instead of paying the full amount of the interest the debtor pays to his "creditor the interest less the tax, he has fulfilled his obligation, even though "the payment exhausts his cash in hand or, if paid by cheque, leaves nothing "standing to his credit at his bankers. So long as the net interest and no "more reaches the hands of the creditors the Crown has no cause for complaint. "Nor can the Crown be concerned with the form in which the net interest "reaches the hands of the creditor. The creditor may, if he thinks fit, agree "to accept in full satisfaction of the net amount a bill or a bond or a chattel "provided that the money value of what he gets in exchange does not exceed "the net interest due. If this be so, a mortgagor and a mortgagee may validly "agree that, in the event of failure by a mortgagor to pay the net interest "as it falls due, the mortgagee will from time to time accept in full discharge "of the mortgagor's liability to pay it a capital charge for a like amount upon "the mortgage security. As and when each charge takes effect the tax will "have been deducted within the meaning of the rule, for the capital charge "merely takes the place of a payment by the mortgagor of the net amount "and can never exceed that net amount in money value. In our judgment "the arrangement that was made between the mortgagor and the society "in the present case was of that nature."

My Lords, I am not concerned in the present case to consider the first part of this passage in the suggestion that the debtor, if he has only enough money to pay the net amount, is entitled to pay it all to the creditor, having made the prescribed deduction from an amount which he does not possess. It is clear that the interest due may be paid in money's worth in such a way as to discharge the debtor's liability for the interest. But I find myself quite unable to agree that the debtor's liability for the interest was discharged as the result of the arrangement between the mortgagor and the society in that case. I cannot but think that the learned Judges did not sufficiently bear in mind the distinction between debt and security. In my opinion there was no discharge of the debtor's liability for the overdue interest, and the result of the arrangement was the improvement of the security, and an increased liability for

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interest by the overdue interest being made to carry interest. The same result was effected in the present case by the exercise of the option conferred by the indenture of further charge dated 18th May, 1905. Accordingly, I am of opinion that *Lawrence, Graham & Co.'s* case[1] was wrongly decided.

Though the learned Master of the Rolls thought otherwise in the present case, I am of opinion that this case falls within the principle of the decision of this House in *Paton (as Fenton's Trustee)* v. *Commissioners of Inland Revenue*, [1938] A.C. 341; 21 T.C. 626, in which it was held that the practice of banks to add interest to principal by half-yearly rests did not constitute, as between the bank and its customer, a payment of interest by the customer within the meaning of Section 36 (1) of the Income Tax Act, 1918, so as to entitle the trustee of the customer's estate to recover the amount of Income Tax thereon. As my noble and learned friend Lord Macmillan states, [1938] A.C., at page 356; 21 T.C., at page 664: "It is a condition of a claim for repayment of tax on "bank interest under section 36, sub-section (1), that the taxpayer shall have "'paid' to his bank the interest in respect of which he claims repayment of "tax. In my opinion this means that the taxpayer must really, and not "merely notionally, have paid the interest; there must be payment such as "to discharge the debt; the payment must be a fact not a fiction."

I may add three dicta which appear to me to well describe the substance of the transaction presently under consideration. First, from the judgment of Lord Sterndale in In re *Morris*, [1922] 1 Ch. 126, at page 133: "When these "sums of interest come to be paid at the end of the time when payment is "made, although interest has been charged upon them, and although, as a "matter of bookkeeping, they have from time to time been added to capital, "they do not cease to be interest of money—that is to say, they are overdue "interest upon which interest has been paid." Secondly, a sentence from the judgment of my noble and learned friend Lord Russell of Killowen—then Russell, J.—in In re *Jauncey*, [1926] Ch. 471, at page 476: "In the case of "such a provision as is contained in the present deed, which enables the interest "to be capitalised, the interest is not capitalised because it is in fact paid, "but because it has in fact not been paid." Thirdly, a passage from the judgment of the Privy Council in *Raja Raghunandan Prasad Singh* v. *Commissioner of Income Tax, Bihar and Orissa*, (1933) 60 Ind. App. 133, which was delivered by my noble and learned friend Lord Macmillan, and which, in my opinion, is equally applicable in the law of England. In 1904 a new mortgage had been accepted for an amount which included both the principal and the arrears of interest due under a previous mortgage of 1894, which was then discharged. The question was whether the mortgagees had thereby received payment of the arrears of interest; if so, the assessment appealed against would be out of time, but this view was rejected by the Board. Lord Macmillan said, at page 138: "Their Lordships are of opinion that there was in the circumstances "no realization of the principal and interest of the original mortgage of 1894, "and that when the assessees received the new mortgage for Rs. 7,33,135, "which included the principal and interest of the original mortgage, they "did not thereby receive payment or the equivalent of payment of the principal "and interest of the original mortgage. No doubt the grantors of the new "mortgage were not identical with the grantor of the original mortgage and "the property mortgaged was greater in extent, but the substitution effected "cannot in any real sense be described as the equivalent of a realization of "the original mortgage, principal and interest. What happened was that the "assessees received a new and substituted security for an existing debt. To "give security for a debt is not to pay a debt. If the assessees had received

[1] 21 T.C. 158.

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" payment in kind of the amount outstanding on the original mortgage, in " the shape, say, of realizable shares or bonds, the case would have been " different, but they merely received further and better security for their debt. " It is, in their Lordships' view, quite immaterial that the assessees discharged " the original mortgage and all liability under it, for that was merely an " incident in the transaction whereby the new security was substituted for " the old."

Accordingly I am of opinion that there was no payment of interest within the meaning of Rule 21 by virtue of the two instruments dated respectively 9th August, 1935, and 13th September, 1938, executed by Lady Liberty's trustees.

The Respondent submitted a further contention that he was not a person by or through whom any such payment was made within the meaning of Rule 21, on the ground, as I understood, that he was merely handing over the investments specified in the schedule to the heads of agreement dated 20th July, 1939. This contention is clearly untenable, as the heads of agreement make provision for the Crown's claim against the Respondent and provide for the retention of one-half of these investments in joint names as a security for the indemnification of the Respondent, personally undertaken by the Liberty trustees, against all claims by the Crown and all costs by the Respondent in connection with such claim.

I am therefore of opinion that the appeal succeeds; that the judgments appealed against should be set aside, and that the assessment should be upheld, subject to adjustment of the figures in accordance with the decision of this House. The case should be remitted to the Special Commissioners for that purpose. I move accordingly.

Lord Russell of Killowen.—My Lords, I have had an opportunity of reading and considering the opinions of my noble and learned colleagues in this case. Being in agreement with them, I do not find it necessary to say anything except that I concur in the motion which is proposed.

Lord Macmillan.—My Lords, the late Mrs. Beyfus, whom I shall call " the " mortgagor ", was entitled to a reversionary interest under a deed of settlement. On the security of this interest she borrowed from Mrs., afterwards Lady, Liberty, whom I shall call " the mortgagee ", sums of £2,300, £500 and £300 in 1899, 1901 and 1905, respectively. The mortgages which were granted in respect of the loans of £2,300 and £500 stipulated for the payment of interest at 5 per cent. per annum by equal quarterly instalments, and this interest was paid up to 18th May, 1905. When the third sum of £300 was advanced the mortgagor, by the deed which she then executed, agreed that interest on all three loans should thenceforth be at the rate of 5½ per cent. per annum, payable quarterly as before, but the mortgagee agreed to accept payment at the rate of 5 per cent. per annum if made punctually. The third mortgage also provided as follows: "And it is hereby further agreed and declared that " all interest which shall fall due on the said sums of £2,300 £500 and £300 . . . " and shall not be paid within 21 days after the dates . . . appointed " for payment thereof may at the option of the Mortgagee be capitalised . . . " and be added to the principal moneys hereby secured so as to form one " aggregate sum charged on the property hereby mortgaged and carrying " interest at the rate aforesaid ". The mortgagor further covenanted to pay to the mortgagee " the interest on such capitalised interest at the rate afore- " said "; and it was provided that " notwithstanding the capitalisation of " the interest " the mortgagee should remain entitled to exercise " all the " rights powers and privileges of a Mortgagee as if the interest had not been " paid or capitalised ".

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The mortgagee died in 1920 and the mortgagor in 1933. No interest was ever paid by the mortgagor after 1906. She left no estate other than the equity of redemption in the reversionary interest which she had mortgaged. In 1935 the trustees acting under the mortgagee's will executed an instrument whereby, in the exercise of the option conferred by the third mortgage, they " capitalised " as from 18th May, 1935, " so much of the interest fallen " due on the principal sums of £2,300 £500 and £300 . . . as is now capable " of being capitalised ", and added the interest so capitalised to the principal sums " so as to form one aggregate sum charged on the property mortgaged ", carrying interest at the rate provided. On 13th September, 1938, the mortgagee's trustees executed a further instrument capitalising in similar terms as from 18th August, 1938, the interest on the principal sums and on the interest thereon previously capitalised.

The mortgagor's reversionary interest fell into possession on 29th June, 1938, and the proceeds thereof became available towards satisfying the mortgages. The sum as appropriated by the trustees of the mortgage, in accordance with the agreement hereinafter mentioned, was sufficient to repay the three principal sums in full and to leave a balance to meet in part the accrued interest. It is with regard to this balance that the present controversy has arisen. The Appellants, the Commissioners of Inland Revenue, maintain that, notwithstanding the exercise by the mortgagee's trustees of the option of capitalising unpaid interest, the arrears of interest have never lost their character of interest and that the Respondent, the surviving trustee under the settlement, is bound, when making payment to the mortgagee's trustees of the proceeds of the mortgagor's reversionary interest, to deduct and account for Income Tax on the part of the sum which represents arrears of interest. The Respondent resists this claim on grounds which I shall indicate later, but which I may compendiously describe as the *ratio decidendi* of the case of *Commissioners of Inland Revenue* v. *Lawrence, Graham & Co.*, [1937] 2 K.B. 179; 21 T.C. 158. In view of the claim of the Inland Revenue the trustees of the settlement and the trustees of the mortgagee entered into an agreement whereby the former undertook to transfer the reversionary fund to the latter, to be appropriated by them as therein mentioned, and the parties agreed that one-half thereof should be placed in their joint names as a security to the trustees of the settlement against all claims by the Inland Revenue Commissioners.

An assessment was made on the Respondent, as the surviving trustee of the settlement, in respect of the tax alleged to be deductible by him under Rule 21 of the General Rules applicable to all Schedules of the Income Tax Act, 1918, on his paying over to the mortgagee's trustees the available fund in his hands so far as representing arrears of interest. The Special Commissioners discharged the assessment on the ground that the case was ruled by the decision of the Court of Appeal in *Lawrence, Graham & Co.'s* case. On a Case Stated, Macnaghten, J., and the Court of Appeal affirmed the decision of the Special Commissioners, also holding that the case was governed by the decision in *Lawrence, Graham & Co.'s* case. Hence the present appeal by the Commissioners of Inland Revenue.

Before considering the validity of the claim for the Revenue it is, in my view, essential to ascertain first the nature and effect of the contracts between the mortgagor and the mortgagee. The Revenue authorities are not parties to these contracts, which make no reference to their claims. They stand, as it were, outside and intervene only in virtue of their statutory rights. Now, for myself and apart from the highly sophisticated arguments in which the matter has become involved, I should have thought, as indeed I do think,

(Lord Macmillan.)

that the contractual position as between the parties to the mortgages was quite plain. Interest at 5½ per cent. is stipulated for on the three capital sums advanced. If the interest is punctually paid 5 per cent. will be accepted. If the interest is not paid as it falls due the mortgagee has an option to capitalise it and add the interest so capitalised to the principal sums, the aggregate then carrying interest at the rate of 5½ per cent. If there were no option to capitalise, or the option were not exercised, the arrears of unpaid interest at the stipulated rate would accumulate at simple interest. The option to capitalise is an option to exact compound interest. The effect of an agreement to pay compound interest, or to "capitalise" interest, is stated with perfect clarity by Lord Sterndale, M.R., in In re *Morris*, [1922] 1 Ch. 126, at pages 131–3, a statement with which I entirely concur. Such an agreement merely means that the interest at the stipulated rate as it falls due, if it remains unpaid, is added to the borrower's indebtedness and itself yields interest at the stipulated rate. It is, of course, true that if the interest were duly paid the borrower would be entitled or bound when making payment to deduct Income Tax and the lender would be bound to grant a discharge for the full amount of the stipulated interest on receiving that amount less Income Tax. But if the interest is not paid no right or duty to deduct tax arises. The unpaid interest accumulates at the stipulated rate. In the case of a provision "which "enables the interest to be capitalised, the interest is not capitalised because "it is in fact paid, but because it has in fact not been paid", as was said by my noble and learned friend Lord Russell of Killowen, then Russell, J., in In re *Jauncey*, [1926] 1 Ch. 471, at page 476. It is because the interest has not been paid that the rate of 5½ per cent. is applicable. At the end of the day, if funds become available through the realisation of the security for payment of the borrower's indebtedness for principal and interest, then, in paying the part of the indebtedness which consists of accumulated unpaid interest, the right or duty to deduct tax emerges, but not till then. The unpaid interest never ceases to retain its character as interest, although it has from time to time been added to the capital indebtedness and has carried interest in turn. All this seems to me, I confess, reasonably clear and is in exact consonance with Lord Sterndale's view as expounded in In re *Morris*.

But the Respondent has argued strenuously that this is not a true analysis of the situation and he invokes the authority of the judgment of the Court of Appeal in the case of *Lawrence, Graham & Co.*[1]. Lest I do injustice to the Respondent's main contention I shall state it in the words of the third reason appended to the printed Case, which reads as follows: "Because, as "held by the Court of Appeal in the case of *Commissioners of Inland Revenue* v. "*Lawrence, Graham & Co.* on the capitalisation of each instalment of interest "the borrower and the mortgagee should be deemed to have agreed that a "capital charge for the net amount of the interest less tax should be accepted "by the mortgagee in full satisfaction for the sum due by way of interest." If this be accepted as an accurate statement of the import of the judgment of the Court of Appeal in the case of *Lawrence, Graham & Co.*, I agree that it would assist the Respondent's contention. But the Crown maintains that that judgment was erroneous and has brought the present appeal with the avowed object of arguing that it should be overruled.

It will be observed that the Respondent, in his reason which I have quoted, does not in terms state that in a question with the Inland Revenue the interest must be held to have been *paid* on capitalisation. I do not see how he could have said so consistently with the judgment of this House in *Paton (as Fenton's*

(1) 21 T.C. 158.

(Lord Macmillan.)

Trustee) v. *Commissioners of Inland Revenue*, [1938] A.C. 341 ; 21 T.C. 626. That was a case under Section 36 (1) of the Income Tax Act, 1918, whereas the present case is under Rule 21 of the General Rules applicable to all Schedules under the Act, but the condition precedent of the operation of Section 36 (1) and of Rule 21 is the same. The former applies where interest is " paid " to a bank, the latter applies " upon payment of any interest ". In each case, therefore, the first thing to ascertain is whether there has in fact been any payment of interest. Now in *Paton's* case it was sought to be made out that the bank, by the accumulation of interest with capital on a loan account at half-yearly intervals, had in effect been paid the interest as it accrued. The House rejected this argument. Construing the word " paid ", I said that " In my opinion this means that the taxpayer must really, and not " merely notionally, have paid the interest ; there must be payment such as " to discharge the debt ; the payment must be a fact not a fiction."(1) I adhere to this opinion, and I am equally satisfied that the word " payment " in Rule 21 has the same effect. With much respect, I think that the reasoning of Romer, L.J., in delivering the judgment of the Court of Appeal in the case of *Lawrence, Graham & Co.*, [1937] 2 K.B., at page 195 ; 21 T.C., at page 175, is based on a misconception. He proceeds on the view that the contract between the parties provided for the capitalisation, not of the stipulated interest, but of the interest less tax, and that is also the contention of the Respondent in this case. As I have said, I do not so read the contract in the present case, and I should not have so read the contract in the case of *Lawrence, Graham & Co.* I can see no right or duty to deduct Income Tax except when interest is paid, and it is not paid when it is accumulated. There is a manifest confusion between what the lender must accept on payment and what is due. The lender must discharge the borrower's indebtedness to pay interest at the stipulated rate on being paid that interest less tax, but it is quite a different thing to say that what is due under the contract is the stipulated interest less tax. The contract fixes the rate of interest ; the Income Tax Act creates a supervening right or duty to deduct tax. To say the least, the validity would be doubtful of such a contract as Romer, L.J., suggests in *Lawrence, Graham & Co.'s* case (*supra*) whereby the lender agrees to accept in lieu and in discharge of the unpaid stipulated interest an additional capital charge of an amount equivalent to the unpaid interest less tax. At any rate that is not, in my opinion, the legal effect of the contract which your Lordships have to constru in the present appeal. I do not wonder that the Respondent shrank from saying that the " capitalised " interest was " paid " on capitalisation of a sum equal to the interest under deduction of tax, for if there was payment of interest less tax, then, this being a Rule 21 case, it would have been the duty of the payer, presumably the mortgagor, to deliver to the Commissioners of Inland Revenue " an account of the payment . . . and of the tax deducted " out of the payment " with a view to the assessment of the payer. Nothing of the kind was done.

It so happens in the present case that the amount of the fund now available towards satisfying the mortgages is not sufficient after paying the original principal sums to provide enough to pay the arrears of interest, whether those arrears are calculated on a net or a gross basis. But, in my opinion, whatever is paid now out of the available fund to the mortgagee's representatives over and above the original capital loans is, in law, a payment of interest, and, not being made out of profits or gains brought into charge, must suffer deduction of Income Tax, the payer being accountable to the Inland Revenue for the tax so deducted.

(1) [1938] A.C., at p. 356; 21 T.C., at p. 664.

(Lord Macmillan.)

A point was taken on behalf of the Respondent that he was not the person "by or through whom" the interest was payable. So far as I understand the argument, it was based on the terms of the agreement under which the available fund has been handed over to the mortgagee's trustees. But the fund, so far as required to meet arrears of interest, stands in the joint names of the parties. There is no substance in the point.

In my opinion your Lordships should overrule the judgment of the Court of Appeal in the case of *Lawrence, Graham & Co.*(1) and allow the present appeal. The case will have to be remitted in order that the amount of the assessment on the Respondent may be adjusted.

Lord Porter (read by Lord Simonds).—My Lords, in this case the Revenue authorities seek to recover Income Tax in respect of the interest, or part of the interest, payable upon certain loans secured by mortgage. The lender was a Mrs. Liberty; the borrower a Mrs. Beyfus; the security a reversionary interest, and the total amount of the money actually advanced, £3,100. The sum lent was ultimately secured by a deed of 18th May, 1905, under which the interest was to be 5½ per cent. per annum, reducible to 5 per cent. on punctual payment, and payable quarterly on the 18th February, 18th May, 18th August and 18th November: the interest if not paid within 21 days after it became due might, at the option of the borrower, be capitalised as from the date it became due. No interest was in fact paid after 18th August, 1906, until the payment of capital and interest mentioned later. On 2nd May, 1920, Mrs. Liberty died and her will was duly proved by the executors named in it. Mrs. Beyfus died on 11th January, 1933, but no representation was taken out to her estate. On 9th August, 1935, and again on 13th September, 1938, the trustees of Mrs. Liberty's will exercised their option and capitalised the interest which had fallen due. Meanwhile, on 29th June, 1938, the reversionary interest, then in the hands of the Respondent as the sole surviving trustee of the settlement of one R. W. Cosier, fell into possession. After paying all proper charges and expenses this fund was valued at £7,438 12*s.* 5*d.*

The Liberty trustees thereupon claimed that there was owing to them a sum of £8,301 8*s.* 2*d.*, and this they calculated, first, by taking simple interest on the £3,100 from 18th August, 1906, to 18th May, 1935, deducting the appropriate amount of Income Tax due from year to year and capitalising the balance and adding it to the original debt, and secondly, by treating the sum so capitalised in a similar manner up to 18th August, 1938, and then capitalising the balance of interest as before. After that date interest less tax is charged on the final sum so capitalised, but no further capitalisation is resorted to.

Some question was raised by the Crown as to whether the capitalisation was rightly calculated, and whether the gross sum of interest without deducting the appropriate amount of tax should not have been included in the final amount instead of the net amount less tax, but whichever principle is adopted the sum available for answering the debt is less than what is due, and, having regard to the view which I hold, it is unnecessary to consider which calculation is the correct one. In either event the Liberty trustees will get less than the sum they are owed.

Having regard to these facts the Inland Revenue authorities claimed that, before making payment to the Liberty trustees, the Cosier trustees ought to deduct and pay Income Tax on the interest capitalised as aforesaid and on the interest on that interest. The Liberty trustees disputed this contention,

(1) 21 T.C. 158.

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whereupon an agreement in writing was come to between the two sets of trustees on 20th July, 1939. By that document it was agreed that, after deducting certain proper charges and expenses out of the fund, the Cosier trustees should transfer the residue to be appropriated in payment of (1) all proper costs, charges and expenses; (2) the capital sums of £2,300, £500 and £300, making £3,100 in all, and (3) all interest (including capitalised interest) owing under the mortgages.

A further term of this agreement was that one-half of the funds so appropriated should forthwith after such appropriation be placed in the joint names of the two sets of trustees as a security for the complete indemnity of the Cosier trustees against all claims by the Inland Revenue Commissioners and the costs thereof.

In pursuance of this agreement, on various dates in January and February, 1940, the Cosier trustees handed over to the Liberty trustees all the funds (both capital and interest) then remaining in their hands, and one-half now stands in the name of the Liberty trustees and the other half in the joint names of the two sets of trustees. The appropriation is as follows:—

	£	s.	d.
(1) To costs of the Liberty trustees	105	15	10
(2) To repayment of the principal sums	3,100	0	0
(3) To interest thereon (including capitalised interest)	4,399	3	1

The question therefore arises whether the Cosier trustees on paying the principal sum due were under an obligation to deduct some and what sum to answer the claim of the Crown for Income Tax.

The solution depends primarily on the construction of Rule 21 of the General Rules applicable to Schedules A, B, C, D and E, which are contained in the First Schedule to the Income Tax Act, 1918. Leaving out unnecessary expressions that Rule runs as follows: "21.—(1) Upon payment of any interest "of money . . . not payable . . . out of profits or gains brought into charge, "the person by or through whom any such payment is made shall deduct "thereout a sum representing the amount of the tax thereon at the rate of "tax in force at the time of the payment." Sub-rule (2) enacts that the person so deducting shall forthwith render an account to the Commissioners of the amount so deducted.

The deduction is to be made "upon payment", and similarly Rule 19, which deals with annual payments out of profits or gains brought into charge to tax, permits deduction on making the payment, though in that case the deduction is optional, not compulsory, and the deduction is of tax at the rate or rates of tax in force during the period through which the payment was accruing due, not at the rate in force at the time of payment. In each case if the deduction is made its maker is assessed upon the amount so deducted.

The Crown in these circumstances contended that the compulsory deduction required by the Statute could only take place at the moment when actual payment was made to the Liberty trustees, and that the appropriate sum to be deducted was a sum equivalent to tax at the rate then in existence upon so much of the fund as was rightly appropriated to interest (including capitalised interest).

The Respondent, as I understood, agreed that tax was deductible only on payment, but said that the capitalisation of interest under the terms of the mortgage deeds amounted to payment as each sum of interest became due, or at any rate at the date of capitalisation, and that in making this payment

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the tax must be taken to have been deducted by those who made the payment at the rate then due. The argument went on by contending that the payment must be taken to have been made as and when the interest became due by the person then owing the interest, and that this was either Mrs. Beyfus or those representing her estate, and was not, at any rate until after the reversionary interest fell in, the Respondent or his predecessors as trustees of the Cosier estate.

In support of his argument the Respondent relied principally upon the decision in *Commissioners of Inland Revenue* v. *Lawrence, Graham & Co.*, [1937] 2 K.B. 179; 21 T.C. 158. That case, like the present, dealt with the position of trustees of a reversionary interest to pay Income Tax upon the sum available for payment of interest which had passed through their hands on its way to the mortgagee when the reversionary interest fell in. Two points were decided. It was held (1) that the capitalisation of interest from time to time did not constitute a payment or payments of the interest by the notional making of a further loan from the mortgagee to the mortgagor which was then added to the capital sum due, the case of *Commissioners of Inland Revenue* v. *Holder*, [1931] 2 K.B. 81 (affirmed in your Lordships' House upon another ground in [1932] A.C. 624) (16 T.C. 540), was distinguished on the ground that principles applicable to the capitalisation of interest by bankers did not apply to interest due on a mortgage debt; but (2) that the agreement for capitalisation, followed by capitalisation, either because the mortgage deed provided for that result following or because an option was given by it to capitalise by the mortgagor, did amount to payment, since there was an agreement to substitute this capital charge for payment in cash.

It was held, however, that the obligation was only to pay a net sum, namely, the gross sum due less tax; the net sum therefore and not the gross sum should be added to the capital, and the borrower must be taken to have deducted on each occasion the amount due for tax. The judgment goes on, [1937] 2 K.B., at page 196; 21 T.C., at page 176: "This being so, when the respon- "dents paid to the society out of the purchase money the sums that had been "so added to the principal moneys secured they were paying a sum that had "already suffered tax, and were under no liability to make any further "deduction."

So it was said here the Cosier trustees, in handing over so much of the capital sum in their hands as was applicable for the payment of interest, were handing over a sum from which tax had already been deducted; they had received and were paying only a tax-free sum, and although the rest of the estate of the late Mrs. Beyfus (if there had been any) would have been liable for the tax so notionally deducted, the Cosier trustees were not.

My Lords, the representatives of the Crown sought to distinguish that case from this on the ground that the mortgage agreement in the *Lawrence, Graham* case stipulated for net interest only, whereas the present case stipulated for gross interest. Whether the mortgage deed in the former decision did require a payment of net interest only may perhaps be doubted, but whether it did so or not cannot, I think, affect the principles to be applied. If, then, the decision in that case be right, the decision of the Court of Appeal in this case was right also. The Commissioners accordingly argued that, if no valid distinction could be made, the case of *Lawrence, Graham* should be overruled.

My Lords, I cannot think that the provision contained in the mortgage deed now in question, whereby an option was given to the mortgagee to capitalise interest unpaid for 21 days after it became due, amounted to payment. As

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my noble and learned friend Lord Russell of Killowen, then Russell, J., when dealing with the question of capitalised interest, said in In re *Jauncey*, [1926] Ch. 471, at page 476: "In the case of such a provision as is contained in "the present deed, which enables the interest to be capitalised, the interest "is not capitalised because it is in fact paid, but because it has in fact not "been paid."

To the same effect Lord Sterndale in In re *Morris*, [1922] 1 Ch. 126, speaking of capitalisation in a case where capitalisation was not expressly provided for, said, at page 133: "I think that the word 'capitalisation' used in many of "the books quoted is a convenient word, but for the purposes for which it has "been used in the argument before us it is a fallacious word, because it is "taken as referring to capitalisation for all purposes, income tax and otherwise. "I do not think that is the meaning of the word. In my opinion—not to beg "the question—when these sums of interest come to be paid at the end of the "time when payment is made, although interest has been charged upon them, "and although, as a matter of bookkeeping, they have from time to time "been added to capital, they do not cease to be interest of money—that is "to say, they are overdue interest upon which interest has been paid."

Had the sum in question in the present case been bank interest upon a loan, the question whether the interest there had been paid by adding it to the capital sum borrowed would have been determined by your Lordships' decision in *Paton* (*as Fenton's Trustee*) v. *Commissioners of Inland Revenue*, [1938] A.C. 341; 21 T.C. 626. At an earlier date, in *Commissioners of Inland Revenue* v. *Holder*[1], the Court of Appeal had decided that the capitalisation of bank interest ought properly to be regarded as a fresh borrowing of interest by the borrower from the bank followed by the application of the sum so notionally borrowed in payment of the interest due, with the result that there was a payment at the moment of capitalisation. In *Paton's* case your Lordships held that this was not so, and that the debiting of interest in the account did not constitute, as between the borrower and the bank, a payment of interest under Section 36 (1) of the Income Tax Act of 1918.

My Lords, I do not find myself able to distinguish in principle between that case and the one the House is now considering. In each case there is a debt and in each case there is a contract under which, in default of payment, a so-called capitalisation of interest takes place. It is true that in the one case the contract is constituted by the custom of bankers and in the other by a deed of mortgage, but the substance, though not the machinery, is the same.

Capitalisation means no more than that interest, which continues to be interest, shall be treated together with the capital sum due as itself interest-bearing, but does not alter its quality as interest. There being, then, no payment until the funds were handed over in pursuance of the agreement of 20th July, 1939, there could be no earlier deduction, and up to that time no deduction of tax had in fact taken place. The Cosier trustees were, therefore, under an obligation to deduct from the sum paid to the Liberty trustees and account to the Revenue for the tax then due, unless for some other reason they were excused.

It was sought to find such an excuse by a contention that they had not handed over money, and could not deduct money from an obligation which they had met by handing over a commodity. This argument, as to the merits

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(1) 16 T.C. 540.

(Lord Porter.)

of which I say nothing, fails, in my view, *in limine*. I think the Attorney-General was right when he said that under the agreement of July, 1939, the parties were not seeking to avoid payment in sterling—they were merely seeking to arrange a satisfactory position in which the Cosier trustees should retain part of the sum due in order to answer their liability (if any) to account for Income Tax.

I should allow the appeal.

Lord Simonds.—My Lords, the primary question for decision in this case, the facts of which I need not restate, is whether the capitalisation by mortgagees of arrears of mortgage interest is, for the purpose of Rule 21 of the General Rules of the Income Tax Act, 1918, as amended by Section 26 of the Finance Act, 1927, to be regarded as payment by the mortgagor of such interest. The question is the same whether, as in the present case, the capitalisation depends on the exercise by the mortgagee of a contractual right or, as is often the case, takes place automatically under the terms of the mortgage deed when interest is in arrear. This is a question of wide importance, and it is the avowed intention of this appeal to obtain a review of the decision of the Court of Appeal in *Commissioners of Inland Revenue* v. *Lawrence, Graham & Co.*, [1937] 2 K.B. 179; 21 T.C. 158, which answered it in the affirmative. A further question, which has been much discussed in this appeal, but is necessary for decision only if your Lordships accept on the primary question the reasoning of the Court of Appeal, is whether the capitalised interest is the net interest which the mortgagor would pay if he in fact paid it, that is, the interest less Income Tax, or the gross interest without deduction of tax. In the view which your Lordships take of the primary question, I do not find it necessary to express any final opinion upon this second question.

The Court of Appeal in the present case have, as I have indicated, followed their previous decision in *Lawrence, Graham & Co.'s* case.. The *ratio decidendi* in that case is to be found in the excerpt from the judgment, cited by Lord Greene, M.R., in the present case, the conclusion of which is that " a mortgagor " and a mortgagee may validly agree that, in the event of failure by the " mortgagor to pay the net interest as it falls due, the mortgagee will from " time to time accept, in full discharge of the mortgagor's liability to pay it, " a capital charge for a like amount upon the mortgaged security. As and " when each charge takes effect the tax will have been deducted within the " meaning of the Rule ", that is Rule 21, " for the capital charge merely takes " the place of a payment by the mortgagor of the net amount and can never " exceed that net amount in money value."(1) With so much of this citation as is concerned with the question of gross or net interest, I need not deal. But I must express my disagreement with that part of it which purports to be an analysis of what takes place when mortgage interest is capitalised, for it appears to me inaccurate and inconsistent with the reasoning which led to the decision of this House in *Paton* (*as Fenton's Trustee*) v. *Commissioners of Inland Revenue*, 21 T.C. 626. The question in the simplest terms is whether, when the mortgagee capitalises interest, the mortgagor pays it; and the answer, in terms as simple, is that the mortgagee capitalises it just because the mortgagor does not pay it. It is not a form of payment; it is not a substitute for payment: the interest remains unpaid, but it is impressed with a new quality, namely, that it carries interest as if it were capital. The interest was always charged on the security; it adds nothing to speak of it as a capital charge. I will assume that a mortgagee may accept in full satisfaction of interest something that is not money but money's worth. But that assumption

(1) 21 T.C., at p. 175.

(Lord Simonds.)

does not justify the further step in the reasoning of the Court of Appeal that capitalisation of interest is payment of interest. I would accept as an accurate statement of that process the judgment of Lord Sterndale, M.R., in In re *Morris*, [1922] 1 Ch. 126, and would respectfully adopt the observations made upon that case by my noble and learned friend Lord Russell of Killowen in In re *Jauncey*, [1926] Ch. 471.

My Lords, in the interval between the decision of *Lawrence, Graham & Co.'s* case(1) and that of the Court of Appeal in this case, *Paton's* case(2) came before your Lordships' House. I do not find any reference to the former in the latter case. But I cannot reconcile the two decisions. In *Paton's* case the question was whether one who had borrowed money from his bankers " paid " the interest on that money when the bankers, in accordance with their usual practice, debited his account at the close of each half-year with that interest and carried it forward as part of an aggregate interest-bearing debt. To that question this House unanimously answered, No. Lord Atkin cited with approval the observations of my noble and learned friend in In re *Jauncey*, to which I have already referred(3). My noble and learned friend Lord Macmillan, in words which I would venture to repeat as decisive equally of that case and this, said : " It is a condition of a claim for repayment of tax on bank interest " under Section 36 (1) " of the Income Tax Act, 1918, " that the taxpayer shall " have ' paid ' to his bank the interest in respect of which he claims repayment " of tax. In my opinion this means that the taxpayer must really, and not " merely notionally, have paid the interest ; there must be payment such as " to discharge the debt ; the payment must be a fact, not a fiction."(4) I can find no valid distinction between the so-called capitalisation of interest under such a mortgage deed as that now under consideration and the process of adding interest to capital with half-yearly rests according to the practice of bankers which was considered in *Paton's* case. If there is not payment of interest in the one case, so there is not in the other. I am willingly led to the conclusion that *Paton's* case is an authority binding on your Lordships for the proposition that in this case there was no payment of interest when the mortgagees exercised their right of capitalisation.

A further question has been raised whether the Respondent was a person " by or through whom " the payment of interest was made when, upon the falling in of the reversion in the funds constituting the mortgagee's security, the agreement of 20th July, 1939, was reached and carried out. Upon this question I entertain no doubt and will do no more than concur in the opinions expressed by your Lordships.

I concur in the motion that this appeal should be allowed.

Questions put :

That the Order appealed from be reversed.

The Contents have it.

That the assessment be upheld, and that the Cause be remitted to the Special Commissioners to adjust the amount thereof in accordance with the decision of this House, and that the Respondent do pay to the Appellants their costs here and below.

The Contents have it.

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(1) 21 T.C. 158. (2) 21 T.C. 626. (3) *Ibid.*, at p. 660. (4) *Ibid.*, at p. 664.

Mr. Stamp.—On the question of costs, my Lords, there was an arrangement made. The Inland Revenue agreed to pay the costs of the trustee in this case throughout, as between solicitor and client.

Lord Macmillan.—In any event ?

Mr. Stamp.—In any event. It was treated as a very important test action —it was selected for that purpose—and it was not thought right that the costs of it should fall upon the trustee.

Lord Russell of Killowen.—Then we had better say nothing about costs ?

Mr. Stamp.—Unless your Lordships would add to the Order a direction that the Respondent's costs be taxed as between solicitor and client, in case there should be any question as to the amount.

Lord Russell of Killowen.—You mean add to the Order a direction that, in pursuance of the undertaking given on behalf of the Crown, the Respondent's costs be taxed as between solicitor and client and paid by you ?

Mr. Stamp.—If your Lordship pleases.

Lord Russell of Killowen.—We will put that right in the Order.

[Solicitors :—Solicitor of Inland Revenue ; Ranger, Burton & Frost.]