HIGH COURT—9TH NOVEMBER, 1950

COURT OF APPEAL—14TH, 15TH AND 16TH FEBRUARY, 1951

HOUSE OF LORDS—22ND AND 23RD APRIL AND 11TH JULY, 1952

Lilley

v.

Harrison (H.M. Inspector of Taxes)

Harrison (H.M. Inspector of Taxes)

v.

Lilley

Income Tax, Schedule D—Foreign securities and possessions—Arrears of interest on mortgage bonds of foreign company—Payment of arrears postponed by arrangement and made after bonds had been cancelled and replaced by a promissory note—Whether interest assessable—Income Tax Act, 1918 (8 & 9 *Geo.* V, *c.* 40), *Schedule D, Cases* IV *and* V.

The Appellant taxpayer owned $100,000 *mortgage bonds of an American company, which were secured on property which the company wished to sell. Interest on the bonds was in arrear and the amount of interest due to the taxpayer was* $36,000.

Under an arrangement made in December, 1942, *the bonds were cancelled and there was issued to the taxpayer a promissory note for* $100,000 *secured partly by a mortgage on other property owned by the company and partly by a first mortgage note for* $100,000 *issued by the company which had purchased the original property and secured on that property. In accordance with the arrangement, half of the* $36,000 *due to the taxpayer for arrears of interest was paid in June,* 1943, *and the other half in June,* 1944. *The promissory note was paid off in April,* 1944.

On appeal to the Special Commissioners against assessments to Income Tax in respect of the payments representing arrears of interest, made alternatively under Cases IV *and* V *of Schedule D for the years* 1943-44 *and* 1944-45, *the taxpayer contended that before the commencement of each respective year of assessment she had ceased to own the source of the income comprised in the assessment and that accordingly no income from any security or possession out of the United Kingdom arose to her in either year. For the Crown it was contended that the interest was paid under an obligation which was either a continuing liability left over from the cancellation of the bonds, or a liability under the new arrangement made in December,* 1942. *The Commissioners held that there was a binding contract, arising out of the arrangement of December,* 1942, *to pay the sums in question,*

and that this contract constituted a foreign possession. They dismissed the appeal, confirming the assessments made under Case V *and discharging those under Case* IV. *Both sides demanded a Case.*

Held, *that the sums totalling* $36,000 *were income arising from a possession out of the United Kingdom within the meaning of Case* V *of Schedule D.*

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.

At a meeting of the Commissioners for the Special Purposes of the Income Tax Acts held on 18th July, 1949, Mrs. Vera Lilley (hereinafter called " the Appellant ") appealed against two assessments to Income Tax, each in the sum of £3,116, made upon her under the provisions of Case IV, alternatively under the provisions of Case V of the Income Tax Act, 1918, for the year ended 5th April, 1944. She also appealed against two assessments to Income Tax, each in the sum of £3,112, made upon her in a similar manner for the year ended 5th April, 1945.

1. The question raised by this appeal is whether the Appellant is liable to Income Tax in respect of income arising from securities in any place out of the United Kingdom under the provisions of Case IV, Schedule D of the Income Tax Act, 1918, alternatively whether she is so liable in respect of income arising from possessions out of the United Kingdom under the provisions of Case V, Schedule D of the Income Tax Act, 1918, for the years in question, by reason of the matters hereinafter set out.

2. The facts of the case are not in dispute and are set out in the following four paragraphs.

3. The Appellant was the owner of $100,000 8 per cent. second mortgage bonds of O-Cedar Corporation, a United States of America company (hereinafter referred to as " the O-Cedar company ") issued on 27th October, 1930, and due for repayment on 1st October, 1938. The last interest paid on these bonds was for the six months ended 1st April, 1932, and at 1st October, 1937, there was, therefore, a sum of $44,000 interest outstanding. At that date there was a reorganization of the O-Cedar company as a result of which the Appellant received $100,000 6 per cent. second mortgage bonds in respect of the principal of her 8 per cent. second mortgage bonds and 8,800 second preferred shares of $5 each in respect of the arrears of interest.

By reason of the reorganization, the O-Cedar company issued $200,000 6 per cent. second mortgage bonds in all, the remaining $100,000 belonging at the relevant time to O-Cedar Consolidated Trust, Ltd., a United Kingdom company. These bonds were secured by a specific charge on property belonging to the O-Cedar company subject to a first mortgage. The O-Cedar company was precluded from making any payment on the second mortgage bonds while the loan secured by the first mortgage remained outstanding with the result that no interest was paid on them.

4. In 1942 the O-Cedar company wished to sell, free of encumbrances, the property (4501, South Western Boulevard, Chicago), which was the security for the bonds but the proceeds of the sale would only be sufficient to pay off the loan secured by the first mortgage and one-half, with accrued interest, of the 6 per cent. second mortgage bonds. In order not to strain the O-Cedar company's resources, the Appellant was agreeable to the postponement of her claims but it was, nevertheless, necessary for the achievement of the O-Cedar company's object that her holding of 6 per cent. second mortgage bonds should be cancelled along with that of O-Cedar Consolidated Trust, Ltd., which was to be repaid in cash.

5. It was accordingly arranged that in place of the principal amount of her 6 per cent. second mortgage bonds there should be issued to the Appellant a promissory note for $100,000 payable not later than 31st December, 1947, bearing interest at 4½ per cent. *per annum*, and secured by second mortgage on 2246, West 49th Street, Chicago, and by a first mortgage note for $100,000 issued by the Solar Manufacturing Co., the purchasers of 4501, South Western Boulevard, Chicago, and secured on that property.

That left the arrears of interest on the 6 per cent. second mortgage bonds due to the Appellant to be dealt with. They were as follows:

Interest at 6 per cent. *per annum* on $100,000 1st October, 1937, to 31st December, 1942	$31,500
Simple interest to 31st December, 1942, at 6 per cent. *per annum* on arrears of interest	$4,500
	$36,000

6. It was arranged that the O-Cedar company should pay this sum as to one-half in June, 1943, and the balance in June, 1944.

The first mortgage was paid off on 31st December, 1942.

Apart from the payment to the Appellant of the above arrears of interest, the transaction in regard to the 6 per cent. second mortgage bonds was treated as if it had been completed on 31st December, 1942. In fact, the whole of the 6 per cent. second mortgage bonds were cancelled by the Chase National Bank, 6, Lombard Street, E.C.3 on 29th January 1943, and O-Cedar Consolidated Trust, Ltd. received its money on 5th February, 1943. The Appellant received her arrears of interest as follows:

In June, 1943	$18,000
Less: U.S. withholding tax at 30 per cent.	5,400
	$12,600
Sterling proceeds	£3,116 17*s.* 0*d.*
In June, 1944—the like	$12,600
Sterling proceeds	£3,112 12*s.* 9*d.*

On the Appellant's instructions, the promissory note was issued in the joint names of herself and her husband, Thos. Lilley Junr., Esq. Interest on the note was paid on the due dates, 30th June and 31st December each year and no question arises thereon in this appeal. The promissory note was paid off on 27th April, 1944, together with interest from 1st January, 1944, to that date.

7. The following documents, which were exhibited at the hearing, are contained in a bundle, which is annexed to and forms part of this Case(1), comprising the following:—

(*a*) Copies of cables from 19th November, 1942 to 24th June, 1943 passing between Mr. Norman, an attorney in Chicago representing the O-Cedar company, and (with one exception which was sent by the Appellant herself) Mr. Colpitts, an officer of the O-Cedar Consolidated Trust, Ltd. at Slough, England, who represented the Appellant in the negotiations. Included are the two cables dated 7th December, 1942 and 9th December, 1942 referred to in our decision below(1).

(*b*) A letter dated 18th December, 1942 written to the Appellant by The Chase National Bank of New York and her reply thereto dated 31st December, 1942(1).

(*c*) A letter dated 8th February, 1943 written by Mr. Colpitts to Mr. Norman and his reply thereto dated 26th February, 1943(1).

8. It was contended on behalf of the Appellant;

(1) that prior to the commencement of each year of assessment the Appellant had ceased to own the source of the income comprised in the assessment under Case IV of Schedule D for that year and no income from any security out of the United Kingdom within the meaning of Case IV arose to the Appellant in either year of assessment;

(2) that prior to the commencement of each year of assessment the Appellant had ceased to own the source of the income comprised in the assessment under Case V of Schedule D for that year and no income from possessions out of the United Kingdom within the meaning of Case V arose to the Appellant in either year of assessment.

9. It was contended on behalf of the Crown as follows.

(1) The arrears of interest paid to the Appellant in June, 1943 and June, 1944 represented income arising from a foreign security or, alternatively, income arising from a foreign possession.

(2) Such interest was paid pursuant to an obligation which was the source thereof. Such obligation was either a continuing liability left over from the cancellation of the bonds or a liability under a new arrangement or contract made in December, 1942 as evidenced in the various cables.

(3) The assessments under Case IV or alternatively the assessments under Case V should be confirmed. The following cases were referred to:

Champneys' Executors v. *Commissioners of Inland Revenue*, 19 T.C. 375.

Commissioners of Inland Revenue v. *Anderström*, 13 T.C. 482.

10. We, the Commissioners, gave our decision as follows.

An offer from America on behalf of the O-Cedar company, contained in the cable of 7th December, 1942, was made to the Appellant's agent in this country to pay to her arrears of interest due on the second mortgage 6 per cent. bonds, half the payment to be made in June, 1943, and half in June, 1944. This offer was accepted on behalf of the Appellant in the cable of 9th December, 1942. The consideration

(1) Not included in the present print.

for the offer and acceptance was contained in the other terms of the arrangement set out in these and previous cables (including the cancellation of the bonds).

The bonds were cancelled in London on 29th January, 1943, and the other terms of the said arrangement were implemented. The Appellant duly received sums equivalent to the arrears of interest on the bonds in June, 1943, and June, 1944.

We hold that a binding contract existed to pay the sums in question, that this contract constituted a foreign possession within the provisions of Case V, Schedule D of the Income Tax Act, 1918, and that the sums received by the Appellant were income from this foreign possession. The appeal fails.

The figures being agreed, we confirmed the said assessments made under the provisions of Case V, Schedule D and discharged the said alternative assessments made under the provisions of Case IV, Schedule D.

11. The Appellant and the Crown immediately after the determination of the appeal declared to us their 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,
R. A. Furtado,
} Commissioners for the Special Purposes of the Income Tax Acts.

Turnstile House,
94/99, High Holborn,
London, W.C.1.
17th February, 1950.

The case came before Danckwerts, J., in the High Court on 9th November, 1950, when judgment was given against the Crown, with costs.

Mr. Frederick Grant, K.C., and Mr. G. G. Honeyman appeared as Counsel for the taxpayer and Mr. F. Heyworth Talbot, K.C., and Mr. Reginald P. Hills for the Crown.

Danckwerts, J.—There is an appeal by the taxpayer in this case and a cross-appeal by the Inspector of Taxes from the decision of the Special Commissioners.

The matter arises in this way. The Appellant taxpayer was the owner of $100,000 mortgage bonds of an American company called the O-Cedar Corporation. In 1942 the American company desired to dispose of the property which was security for the bonds and upon which property there was a first mortgage which had priority. Accordingly, an arrangement was entered into between the parties which has given rise to the present situation. Interest had not been paid on the Appellant's bonds for a considerable time and the arrears amounted to a sum of $36,000. It was arranged that the bonds which she had should be cancelled and that there should be issued to her a promissory note for $100,000, payable not later than 31st December, 1947, bearing interest at the rate of $4\frac{1}{2}$ per cent. per annum (whereas the bonds had borne interest at 6 per cent.) and secured by a second mortgage on some new property and by

a first mortgage note for $100,000 issued by the Solar Manufacturing Company, which had purchased the original property, and secured on that property. Also, the Appellant agreed that the $36,000 interest which was owing to her should be postponed, in the sense that the American company agreed to pay one half in June, 1943, and the balance in June, 1944, and those payments of the $36,000 were duly made. The date when the bonds were cancelled was 29th January, 1943.

The Appellant has been assessed in respect of the payments of the $36,000 which were made to her in respect of two years ending 5th April, 1944, and 5th April, 1945. So it will be observed that the cancellation of the bonds took place before the beginning of the first of those two financial years. The claim for tax has been made under Schedule D and alternatively under Case IV or Case V, Case IV being tax in respect of income arising from securities out of the United Kingdom and Case V being tax in respect of income arising from possessions out of the United Kingdom.

It is contended on behalf of the Appellant that she is not liable to pay tax on the income which she received in the financial years ending 5th April, 1944, and 5th April, 1945, because the bonds were cancelled in the preceding year, and therefore during those years of assessment she did not possess the source from which the income was obtained.

The Crown, on the other hand, contend that that source must necessarily have remained and that either it was the original source still subsisting as a source in the financial years in question or, alternatively, that it was by virtue of the contract which was made, in the manner I have mentioned, in December, 1942, and therefore that the contract was the source and that tax was payable under Case V as being income from a foreign possession.

I should mention that there was an alternative submission by Mr. Grant on behalf of the Appellant that if the latter basis was the correct one to consider the payments were capital and not income.

It seems to me that the payments were received as income because they were interest. It is quite true that the Special Commissioners in their finding have found that the Appellant " received sums equivalent to the " arrears of interest on the bonds in June, 1943, and June, 1944 ", but it seems to me that what really happened was that she was entitled to $36,000 interest and that she did eventually get that interest. All that happened in the arrangement that was made in December, 1942, was that her present right to receive the $36,000 interest was postponed until June, 1943, as regards half and until June, 1944, as regards the other half. Therefore she received, when it became due, the interest, and she merely agreed to postpone payment ; and for that I think there was consideration in the advantage which she obtained as regards payment of her principal sum of $100,000 under the arrangements which were made as I have described.

That being so it seems to me that the source of the income which she received was the same original source throughout, that is to say it was the bonds which she had formerly possessed. Her right had accrued by virtue of her ownership of the bonds. Therefore it seems to me that the Appellant did not have that source of income in the years of assessment in question and by reason of that she could not be taxed as on the income

(Danckwerts, J.).

of a foreign security under Case IV of Schedule D; and it also seems to me that it is not the correct view, therefore, to regard her source of income as being a new contract made at the end of December, 1942, and therefore something which can be regarded as a foreign possession.

It seems to me that the source plainly was a foreign security, but though the source was a foreign security, at the material date she did not possess the foreign security and therefore under the provisions of the Income Tax Acts she is not liable to be assessed in respect of that income.

Therefore it seems to me that the appeal of the Appellant succeeds and the appeal of the Inland Revenue, which was in respect of the refusal to accept that case under Case IV, fails. Therefore the Appellant is entitled to her costs.

I hope I have expressed that part about the appeals correctly?

Mr. Heyworth Talbot.—Yes, my Lord, quite correctly.

Danckwerts, J.—Very well.

An appeal having been entered against the above decision, the case came before the Court of Appeal (Sir Raymond Evershed, M.R., and Jenkins and Hodson, L.JJ.), on 14th, 15th and 16th February, 1951, when judgment was given unanimously in favour of the Crown.

Mr. Frederick Grant, K.C., and Mr. G. G. Honeyman appeared as Counsel for the taxpayer, and Mr. F. Heyworth Talbot, K.C., and Mr. Reginald P. Hills for the Crown.

Sir Raymond Evershed, M.R.—We need not trouble you, Mr. Talbot.

The question which arises in this case is, as Mr. Grant has truly said, a very narrow one upon analysis. It turns upon the effect of a transaction, a bargain, made in December, 1942, between Mrs. Vera Lilley, whom I will call the taxpayer for the purpose of this judgment, and a corporation known as the O-Cedar Corporation, which was a corporation established in the City of Chicago. Immediately before this bargain Mrs. Lilley owned a series of bonds of the O-Cedar Corporation called second mortgage bonds for the total amount of 100,000 United States dollars. Those bonds carried interest at the rate of 6 per cent. but there appears to have been a provision in the bonds (and I say " appears " because the form of bond was not annexed to the Case or put in evidence, and we have not seen it) that so long as anything remained outstanding upon the first or prior bonds nothing should be payable to the second bondholder either for principal or interest. Now both the first and second bonds were secured upon certain real property in Chicago. The interest under the second mortgage bonds at the time of this bargain had been, therefore, accruing, but because the first mortgage bonds remained undischarged nothing was payable on the second bonds, and Mrs. Lilley could not demand payment of anything in respect of interest or in respect of her capital.

(Sir Raymond Evershed, M.R.)

In the year 1942, however, the Chicago Corporation had the opportunity, of which they desired to avail themselves, to dispose of the premises in Chicago on which both the first and second bonds were secured. The price offered was not sufficient to discharge in full what was due or would become immediately due and payable both to the first and second mortgage bondholders. The corporation therefore approached the persons concerned, including Mrs. Lilley, the taxpayer, with a view to arriving at an arrangement which would enable the company to take advantage of the offer for the sale of these premises. It is I think important to bear in mind that so soon as the sale became effective and the purchase money was applied in discharging what was due under the first mortgage bonds for principal and interest—so soon as that could happen, by arrangement or otherwise, then, and for the first time, there sprang into existence an immediate obligation on the part of the company to pay the arrears of interest on the second mortgage bonds which had been accruing. The form which the bargain took (so far as material) was this. There was an exchange of cables between two individuals, a Mr. Norman and a Mr. Colpitts, representing respectively the Chicago corporation and the taxpayer; and it is necessary for me to read the greater part of two of such cablegrams, for they constituted the bargain then made between the taxpayer and the corporation. The question, as will be seen, is what was its effect. The first cablegram from the agent of the Chicago corporation was as follows (it was addressed to Mr. Colpitts, the taxpayer's agent): "Please deposit second mortgage bonds Chase London with written "instructions providing for endorsement of cancellation upon cabled "assurance to Chase from Chicago Title and Trust Company that latter "holds subject to order of depositing bondholders first $131,000 cash less "Federal taxes required to be withheld on interest portion second note of "O-Cedar Corporation for $100,000 payable jointly Thomas and Vera "Lilley on or before five years from date with interest 4½ per cent. secured "by second mortgage 2246 West 49th Street property and by $100,000 first "mortgage note of Solar Manufacturing Company which note in turn is "secured by mortgage of 4501 South Western Boulevard property third "my written opinion approving O-Cedar note and security. Solar Note "will have prepayment clause and will be secured only by the property "mortgaged. Propose paying balance of interest on second mortgage "bonds half June first 1943 half June first 1944." Then there are some other sentences which I think I can omit.

Now by way of expansion, that cablegram, as is conceded, contained this offer on behalf of the O-Cedar Corporation: first, that if the taxpayer will deposit for cancellation her second mortgage bonds and thereby enable the Chicago corporation to complete the sale of the property, 4501, South Western Boulevard, then the corporation will issue to Mrs. Lilley, the taxpayer, a five-year promissory note for $100,000, the same sum as was the principal sum secured by her second mortgage bonds, with certain added securities and a guarantee which I need not detail; and that they also propose (and I do not for the moment attempt to paraphrase this) "paying balance of interest on second mortgage bonds half June first 1943 "and half June first 1944."

That being the proposal, Mr. Colpitts cabled back: "Mrs. Lilley "agreeable to latest proposal contained cable received December seventh," with a certain proviso which strictly made it not an acceptance but a

(Sir Raymond Evershed, M.R.)

counter-offer ; but as the point made did not give rise to any difficulty we may take it that the two cables I have read sufficiently show what were the material terms of the bargain that was made.

As a result the taxpayer did deposit her second mortgage bonds with the Chase National Bank in London for cancellation, and the bonds were in fact, so it appears, burnt, clearly showing an intention that they should cease, as it is said, to have any further significance at all. Mrs. Lilley, the taxpayer, then received a five-year promissory note, and on the dates which I have mentioned, 1st June, 1943, and 1st June, 1944, she also received the sterling equivalents, less certain American taxes, of $18,000 on each occasion. That figure was arrived at in this way. Though the actual dates when the bonds were deposited and the promissory notes were issued and so on were not the same, it appears that the date for the purpose of making the necessary calculations on which the bonds should be treated as cancelled was 31st December, 1942. By that time the arrears of interest on the taxpayer's bonds (which arrears appear to have carried interest to a certain extent) amounted to $36,000 exactly. No further interest ran on the bonds, and therefore on each of the dates, 1st June, 1943, and 1st June, 1944, a sum of $18,000 or half the $36,000, became payable and that sum was in fact paid. When the taxpayer received the sterling equivalent, which was a little more than £3,000, the question arose—and this is the matter now before the Court—whether she was liable to pay English Income Tax in respect of those two sums under Schedule D of the 1918 Act.

It will I think be sufficient for the purpose of this judgment to say that the claim of the Crown to tax these sums is made by virtue of Paragraph 2 of Schedule D, alternatively as falling either under Case IV (namely, " Tax in respect of income arising from securities out of the United " Kingdom . . . ") or under Case V (namely, " Tax in respect of income " arising from possessions out of the United Kingdom ").

Put in its briefest form—indeed, I think, in its most forceful and attractive form—the taxpayer's case is this. It is said that every right which Mrs. Lilley, the taxpayer, had under the bonds, was, by the terms of this arrangement in 1942, cancelled and put an end to altogether, and as consideration for her agreeing to that cancellation the Chicago corporation promised to pay her by two instalments a sum of cash, *viz.*, $36,000. Those, says the taxpayer, are the plain facts of the case. However else it might have been done and by whatever other form a similar result would have been achieved, that in fact is the plain meaning of the cables, and it is demonstrated by the subsequent destruction of the bonds. Now, says she, on those facts the Crown is really on the horns of a dilemma. Either it must be admitted, once the facts are stated rightly as I have now stated them, that the only claim which the taxpayer could ever have had to receive the two instalments of $18,000 and the only source from which those two payments could have arisen is the bargain of 1942, a bargain to pay a sum of money in consideration for the total cancellation of all previously existing rights, and such a sum of money is not by any ordinary usage of language income at all, for it does not arise from either securities or possessions out of the United Kingdom, or it must be claimed (and this is the other horn of the dilemma) that the $36,000 can be treated as attributable or as having been attributable to the bonds ; but if so then, those bonds having gone, the taxpayer had ceased to possess the source of the income at the relevant dates which the Crown sought to tax it. That is the case put by the taxpayer and it was the second part of it which appealed particularly to Danckwerts, J.

(Sir Raymond Evershed, M.R.)

Before the Special Commissioners the taxpayer was unsuccessful. The way that they put the case was this. They said: "An offer from America "on behalf of the O-Cedar company, contained in the cable of 7th "December, 1942, was made to the Appellant's"—the taxpayer's—"agent "in this country to pay to her arrears of interest due on the second "mortgage 6 per cent. bonds, half the payment to be made . . ." and then they refer to the dates. "This offer was accepted on behalf of the "Appellant in the cable of 9th December, 1942. The consideration for "the offer and acceptance was contained in the other terms of the arrange-"ment set out in these and previous cables (including the cancellation of "the bonds). The bonds were cancelled in London on 29th January, "1943, and the other terms of the said arrangement were implemented. "The Appellant duly received sums equivalent to the arrears of interest "on the bonds in June, 1943, and June, 1944. We hold that a binding "contract existed to pay the sums in question, that this contract consti-"tuted a foreign possession within the provisions of Case V, Schedule D "of the Income Tax Act, 1918, and that the sums received by the Appel-"lant were income from this foreign possession."

Now the taxpayer challenged the validity of that conclusion on the ground that if the source out of which, and out of which alone, the two sums sought to be taxed had arisen was the contract contained in the cables, and if that contract had contained a term, also implemented, for the total cancellation of the bonds, then these two sums were not income at all. They were simply two sums of money which the company promised to pay in consideration for the cancellation of all and every right under the bonds. When the matter was before Danckwerts, J., the taxpayer succeeded, not indeed upon that simple presentation of the case but by turning, so to speak, to the other horn of the dilemma as I have already indicated. Danckwerts, J., said—and this is the basis I think of his judgment—". . . it seems to me that the source of the income which she "received was the same original source throughout, that is to say it was "the bonds which she had formerly possessed. Her right had accrued by "virtue of her ownership of the bonds. Therefore it seems to me that "the Appellant did not have that source of income in the years of assess-"ment in question and by reason of that she could not be taxed as on the "income of a foreign security under Case IV . . ."(1) nor as on the income of a foreign possession under Case V.

Now the phrase "source of income" does not occur in the two passages from Schedule D that I have read. It finds particular expression in the Finance Act, 1926, which was passed following two decisions, *National Provident Institution* v. *Brown*, 8 T.C. 57, and *Whelan* v. *Henning*, 10 T.C. 263, to which we have been referred. I do not think it necessary for the purposes of this judgment to turn at all to those cases or to read any parts of Sections 22, 29 or 30 of the Finance Act, 1926, for I do not think it is necessary to consider whether any particular source of income has ceased. There is no dispute between the parties upon that matter.

I think, as Mr. Grant has said, the whole question turns—and it is a short point—upon what really was the nature of this transaction in 1942. I have come to the conclusion that upon a true view of its nature the Crown is entitled to succeed and that it is not really placed in the unhappy position of being upon the horns of a dilemma. If it were I can see that whichever horn it was placed upon would be equally fatal.

(1) p. 349. *ante*.

(Sir Raymond Evershed, M.R.)

I think it is necessary to determine whether, on the true view of what I will call the 1942 transaction, the two sums of $18,000 which were payable—and paid—to the taxpayer on 1st June, 1943, and on 1st June, 1944, were sums which the Chicago corporation promised to pay as part of the consideration for the total cancellation by the taxpayer of her previous rights under her second mortgage bonds, so that those two sums were neither more nor less than cash sums which the corporation were contractually bound to pay and which were therefore distinct from and had none of the characteristics of the sum of $36,000 accrued and unpaid interest under the bonds; or whether they were two deferred instalments of the accrued interest under the second mortgage bonds, the right to which sum of interest was, notwithstanding the cancellation, preserved and kept alive for the taxpayer as part of the bargain. I think it was the latter. I think the effect of the 1942 bargain was first, that the principal sum of $100,000 due under the second mortgage bonds on the sale of the property was replaced by the five-year promissory note for a similar sum of $100,000; second, that the charge on the security created by the second mortgage bonds was vacated and discharged; and third, that the obligation to pay the accrued interest under the bonds, which on a calculation up to the date of the cancellation was found to amount to $36,000, was not released, but payment of that sum, which as a result of the other parts of the bargain then became for the first time immediately due, was postponed, as to one half to 1st June, 1943, and as to the remainder to 1st June, 1944, without any further interest accruing in the meantime. In other words, I think that the bargain *quoad* accrued interest was (*a*) that the taxpayer promised not to enforce payment of the accrued interest till, as to half, 1st June, 1943, and as to the remainder till 1st June, 1944; and (*b*) that the corporation acknowledged its liability for such interest, but undertook to pay it by the instalments and on the dates abovementioned.

It follows in my judgment that the contract effected by the exchange of cables consisted not merely of the cables themselves but incorporated the terms of the second mortgage bonds to the extent necessary, at any rate, to define and quantify the interest mentioned in, and promised to be paid by, the cables. Only by reference to the bonds could a meaning and a precise figure be given to the reference to interest in the cables. In other words the terms of the bonds as regards interest were, notwithstanding the cancellation, kept alive by the cables to the extent necessary to preserve the obligation to pay and the right to receive the interest, which up to the date of the transaction had not been payable at all; but that obligation and that right were in certain respects qualified by the contractual terms contained in the cables themselves.

In the result, in my judgment, the sum of $36,000 retained its character of interest arising out of or under the second mortgage bonds though certain of the incidents affecting that interest were altered by the cables. If the sum of $36,000 retained, as I hold it did, its character as interest or income, it should follow logically that it had a source, and the source was the contract to pay such interest which was originally contained in the mortgage bonds and remained operative, albeit that the bonds were cancelled as regards other aspects of them, and although the original contract was qualified as I have said by the terms of the cables.

Many analogies have been used. I think a somewhat similar case would inevitably result if a lease was cancelled in the sense of the demise being put an end to and at the same time a bargain was made whereby

(Sir Raymond Evershed, M.R.)

the landlord forbore to sue for arrears of rent, say, until six months had passed. It does not seem to me that the cancellation of the lease, the determination of the demise, would be held to have discharged or affected or altered the nature of the sums outstanding on arrears of rent when, in fact, they were paid and received. However that may be, if I am right, the bundle of rights which made the basis on which the sum of $36,000 was paid amounted, I think, clearly to possessions abroad within the meaning of Case V, and those possessions undoubtedly continued to subsist at all material dates.

I have said that I thought it unnecessary to refer to the cases but I conclude by a brief reference to one case which was cited, namely, *Champneys' Executors* v. *Commissioners of Inland Revenue,* 19 T.C. 375. I hope I shall not be held to have succumbed to the minatory part of Mr. Hills' argument, but at any rate that case gives me this comfort. That was a case where a reorganisation of the obligations of a certain company in England took place so that certain arrears of interest of long standing became payable pursuant to the arrangement in certain future events, and in certain future events only. They were eventually paid, the conditions for their payment having been fulfilled. The question in the case, which came before this Court, was a strictly limited question : whether the sums when received should be treated as income of the year of receipt or whether they should relate back to the years when they originally accrued due, a matter which was very significant for the taxpayer in that case because he was liable to Surtax or Super-tax. The earliest of these arrears were in respect of years before either Surtax or Super-tax had been invented at all. It is significant that nobody thought of taking the point that in truth these sums had lost their original income character altogether as a result of the reorganisation and that therefore they were not taxable as income at all. I think that some comfort is to be derived from that circumstance in *Champneys'* case.

For the reasons which I have tried to formulate, I have arrived at a conclusion in favour of the Appellant. The case is a short one, and I am afraid that my judgment has been unduly long, but it has not been easy to express in precise language. Any imperfections in the judgment are in no way due to any lack of clarity or forcefulness in the arguments on both sides, for which I am most grateful.

Jenkins, L.J.—For the reasons fully stated by the Master of the Rolls, to which I find nothing I can usefully add, I agree that the appeal should be allowed and that the assessment under Case V of Schedule D restored.

Hodson, L.J.—I agree, and have nothing to add.

Mr. Heyworth Talbot.—My Lord, then the Order will be that as regards the Case V assessment . . .

Sir Raymond Evershed, M.R.—It comes back really to the Order made by the Special Commissioners.

Mr. Heyworth Talbot.—Yes, my Lord. Your Lordship remembers there were two separate appeals.

Sir Raymond Evershed, M.R.—I have said nothing about Case IV ; it was not necessary. I thought you said that if you succeeded on Case V you would not bother about Case IV.

Mr. Heyworth Talbot.—No ; but your Lordship will dismiss our appeal as regards Case IV.

Sir Raymond Evershed, M.R.—Very well ; yes.

Mr. Heyworth Talbot.—But I do submit that we are entitled to our costs because we have substantially succeeded.

Mr. Grant.—I submit there should be the usual Order, as regards Case V, appeal allowed ; as regards Case IV, appeal dismissed with costs.

Sir Raymond Evershed, M.R.—That is I think really an argument for the Taxing Master, but clearly the great bulk of the argument was directed to this. I think that it would be simpler to deal with it in this way.

Mr. Grant.—There is no doubt about that. On the other hand, there have been some costs incurred, because if my learned friends had stuck to their position as regards Case V it would have been all right, but they have chosen the second string, which was a bad one anyhow, in my submission.

Sir Raymond Evershed, M.R.—I was wondering whether this would meet it. Suppose we said the Crown should have three-fourths of the costs of the appeal?

Mr. Heyworth Talbot.—I am perfectly happy. That is perhaps the easiest way of doing it.

Mr. Grant.—Yes.

Sir Raymond Evershed, M.R.—Very well.

Mr. Grant.—Will your Lordships give my client leave to appeal to the House of Lords if she so desires after consideration of the judgment? Your Lordships appreciate it is a point of some importance, and your Lordships are taking a different view from that taken by the learned Judge.

(*The Court conferred*)

Sir Raymond Evershed, M.R.—What I am troubled about, Mr. Grant, is this. I agree with you that really in the last resort it depends on the view you take of the precise bargain that was made, and upon that it is not very clear or precise.

Mr. Grant.—Like every case it depends upon its own facts, but I do submit with respect that there is a substantial point behind it.

Sir Raymond Evershed, M.R.—Is there?

Mr. Grant.—I should have submitted there was. If I may say so, my learned friends thought there was ; they certainly regarded it as a case of importance. I think your Lordship would certainly have had an applica-

tion from that side if your Lordships' decision had been the other way. It does go down to first principles here. I think my learned friends would agree with that.

Sir Raymond Evershed, M.R.—What do you say about this, Mr. Talbot?

Mr. Heyworth Talbot.—We of course on this side are accustomed to leave such a decision entirely to the discretion of the Court without adding any observations unless we are asked to do so. But here I must concede that we have throughout regarded this case as raising a point of high principle and I think I may say that we should certainly have gone on—or, I should say, we would have hoped for leave to go on.

Sir Raymond Evershed, M.R.—Do you mean high in its moral tone?

Mr. Heyworth Talbot.—Certain observations that fell from my learned junior certainly suggested that there were moral, ethical and legal issues involved here.

Sir Raymond Evershed, M.R.—I think as there has been a difference of judicial opinion it would be right to give leave, but I have expressed a doubt.

Mr. Grant.—If your Lordship pleases.

Application—19*th February*, 1951

Mr. Reginald P. Hills.—My Lord, with regard to the case of Mrs. Lilley and the interest on the cancelled mortgage, your Lordship will remember the effect of the Order was to uphold the assessment under Case V, and it was admitted, if that was right, that the assessment under Case IV must go.

Those appearing for the Crown forgot to ask, when my learned friend Mr. Grant applied for leave to appeal to the House of Lords, in order to keep the alternative assessment open, to have a parallel leave against the Order for assessment. I have a letter here from the solicitors to the other side, saying they have no objection to this.

Sir Raymond Evershed, M.R.—Yes, I expect the Order has not been drawn up yet.

Mr. Hills.—I expect not.

Appeals having been entered against the above decision, the case came before the House of Lords (Lords Jowitt, Porter, Oaksey, Morton of Henryton and Reid) on 22nd and 23rd April, 1952, when judgment was reserved. On 11th July, 1952, judgment was given unanimously in favour of the Crown, with costs.

Mr. Frederick Grant, Q.C., and Mr. G. G. Honeyman appeared as Counsel for the taxpayer and the Attorney-General (Sir Lionel Heald, Q.C.), Mr. F. Heyworth Talbot, Q.C., and Sir Reginald Hills for the Crown.

Lord Porter.—My Lords, my noble and learned friend, **Lord Jowitt,** has asked me to say that he has read the opinion of my noble and learned friend, Lord Morton of Henryton, and has nothing to add to it.

I myself have had a like opportunity, and I also agree with that opinion.

Lord Oaksey.—My Lords, I too have had the advantage of reading the opinion in print which is about to be read by my noble and learned friend, Lord Morton of Henryton, and I have nothing to add to it.

Lord Morton of Henryton.—My Lords, on 1st October, 1937, Mrs. Vera Lilley became the holder of $100,000 6 per cent. second mortgage bonds issued by an American corporation, O-Cedar Corporation (hereafter called " the company ").

Your Lordships have not seen any of these bonds, but it is apparent from the Case Stated that they contained four provisions which are relevant for the purposes of this appeal: (1) an agreement to pay the principal sum of $100,000; (2) an agreement to pay interest thereon at the rate of 6 per cent. per annum; (3) a specific charge on property known as 4501, South Western Boulevard, Chicago, subject to a first mortgage thereon; (4) a provision that the company should not make any payment of principal or interest on the bonds while the loan on the said first mortgage remained outstanding.

In the year 1942 the company wished to sell, free from incumbrances, the property on which the bonds were charged, and in the month of December, 1942, an agreement was entered into between the company (represented by a Mr. Norman) and Mrs. Lilley (represented by a Mr. Colpitts) with the object of enabling the sale to be carried through. At the time when this agreement was made the first mortgage had not been paid off, and accordingly no interest had ever been paid on the bonds. The terms of the agreement were set out in two cables dated respectively 7th and 9th December, 1942. The position as to interest on the bonds is dealt with by the following words, which occur in the first telegram: " Propose paying balance of " interest on Second Mortgage Bonds half June First 1943 half June First " 1944 ".

That proposal was accepted, and the other terms of the agreement were that Mrs. Lilley's bonds should be " cancelled " and that in place of the principal sum owing on the bonds there should be issued to Mrs. Lilley a promissory note for $100,000, secured in a manner which is irrelevant for the present purpose. The promissory note was issued in December, 1942, and the bonds were cancelled on 29th January, 1943.

The first mortgage on the Chicago property was paid off on 31st December, 1942, and at that date the arrears of interest on Mrs. Lilley's bonds amounted to $36,000. That sum was paid by the company in two equal instalments in June, 1943, and June, 1944, and the question arising on this appeal is whether the taxpayer is chargeable with tax upon these two sums under Case IV or Case V of Schedule D in the Income Tax Act, 1918.

My Lords, in my view the sums so paid were " income arising from a " possession out of the United Kingdom " within the meaning of Case V of Schedule D. They were income because they were the " balance of interest " on Second Mortgage Bonds " referred to in the cable of 7th December,

(Lord Morton of Henryton.)

1942, and the " possession " from which they arose was the agreement for payment of interest contained in the bonds and modified as to dates of payment by the agreement contained in the two cables.

This income did not arise " from a security out of the United Kingdom " within Case IV of Schedule D, because upon the cancellation of the bond the contractual right of Mrs. Lilley to require payment of these sums was no longer secured by a charge on the Chicago property. It was contended by Counsel that the agreement to pay interest which was contained in the bonds became of no effect when the bonds were cancelled, but I cannot accept this contention. To my mind, it was a term of the agreement for cancellation of the bonds that the agreement to pay interest contained therein should remain in operation but should be modified as to dates of payment, and the cancellation could only take effect subject to that term. When the cables were exchanged, the company was under a contractual obligation to pay this interest as soon as the first mortgage was paid off, and I can only construe the company's words, " Propose paying balance of interest on Second " Mortgage Bonds half June First 1943 half June First 1944 ", as a proposal that that obligation should remain on foot but should be discharged on the dates mentioned. The result was that the charge upon the Chicago property was released and the agreement to pay the principal sum was cancelled, but the agreement to pay interest was only modified.

The true view of the matter was put very happily by the Master of the Rolls as follows(1): " . . . the terms of the bonds as regards interest were, " notwithstanding the cancellation, kept alive by the cables to the extent " necessary to preserve the obligation to pay and the right to receive the " interest, which up to the date of the transaction had not been payable at " all ; but that obligation and that right were, in certain respects, qualified " by the contractual terms contained in the cables themselves. In the result, " in my judgment, the sum of $36,000 retained its character of interest arising " out of or under the second mortgage bonds, though certain of the incidents " affecting that interest were altered by the cables. If the sum of $36,000 " retained, as I hold it did, its character as interest or income, it should " follow logically that it had a source, and the source was the contract to " pay such interest which was originally contained in the mortgage bonds " and remained operative, albeit that the bonds were cancelled as regards " other aspects of them, and although the original contract was qualified as " I have said by the terms of the cables."

I realise that there is another possible view of the transaction, namely, that the agreement to pay interest which was contained in the bonds perished with the cancellation of the bonds, and that Mrs. Lilley's right to receive the sums in question rested on an entirely new agreement contained in the cables. Even so, I think that the Crown's claim to tax is well founded. That which was agreed to be paid was the " balance of interest " on second mortgage bonds ". The sums in question were originally interest on a sum of $100,000, and I cannot see that they ever lost their quality of interest. All that happened was that one contract to pay this interest was cancelled and another contract to pay this same interest was substituted for it, the payer and the recipient remaining the same. This being so, the present case is, in my view, plainly distinguishable from cases in which a right to receive income *in futuro* is sold for a lump sum presently payable.

(1) p. 354. *ante*.

(Lord Morton of Henryton)

I would dismiss both appeals. As the Crown has, in substance, been successful in your Lordships' House, I would order Mrs. Lilley to pay the costs of these appeals and would leave undisturbed the order of the Court of Appeal as to costs.

Lord Reid.—My Lords, for some years before 1942 the Appellant had held a $100,000 6 per cent. second mortgage bond of an American company. The sum due under this bond was secured on a property in Chicago which belonged to the company, and it was provided that the interest on the bond should not be paid so long as the first mortgage on the property remained. By 1942 the interest amounted to a large sum.

In 1942 the company wished to sell the property free of these mortgages, but the company was unable or at least unwilling to pay immediately the sums due to the Appellant, and a number of cables passed between the company's agent and the Appellant or her agent. On 19th November, 1942, the company proposed that the Appellant's bond should be cancelled on the company granting a promissory note for $100,000 secured over other property and that the balance of interest to the date of cancellation (including some compound interest) should be treated as open account payable at a later date. The Appellant agreed that the interest on her bond should be treated as open account, and after some further communications the company on 7th December, 1942, requested the Appellant to deposit her bond with a bank in London with instructions providing for its cancellation when the company had deposited the necessary documents in Chicago. The cable contained this sentence with regard to interest: "Propose paying balance "of interest on Second Mortgage Bonds half June First 1943 half June "First 1944". The Appellant agreed to this proposal and on 29th January, 1943, the bond was cancelled.

The company duly met its obligation and on each of the dates 1st June, 1943, and 1st June, 1944, the Appellant received £3,116 17*s.* 6*d.*, the sterling proceeds of the sums paid by the company. The Appellant was assessed to Income Tax on these sums under Case V, or alternatively Case IV, of Schedule D.

There are two possible views about the obligation which was discharged by payment of these sums. One is that, although the parties agreed to cancel the bond and it was in fact cancelled, they intended that the obligation in the bond to pay interest should continue in force modified as to the date of payment. The other, which I prefer, is that they intended all the obligations in the bond to be discharged and to be replaced by the agreement contained in the cables. There is no doubt that the obligation in the bond to repay the principal sum was discharged in its cancellation and that the security in the bond was released; instead a promissory note with different security was granted. There is also no doubt that the only interest which was to accrue after the cancellation of the bond was the interest provided for in the promissory note and no further compound interest was to accrue after that date on the interest which had accrued under the bond before its cancellation. So if the obligation in the bond continued at all it only continued in a much altered form. I do not think that it was necessary to continue the obligation in the bond at all in order to achieve the parties' purpose, and I find it very difficult to spell out of their agreement any provision that any part of the bond should continue in force. What the parties intended is, I think, plain enough: the interest which had already

accrued but had not yet become payable was to be paid in two equal instalments on the dates specified. I think that the legal effect of what they did was to bring to an end the obligation in the bond to pay interest and to create a new obligation to pay the accrued interest on those dates. The amount of the interest then to be paid was not stated in the agreement, no doubt because no date had been fixed for the cancellation of the bond. In fact there was some delay and the bond was not cancelled until 29th January, 1943, and, as interest on the new promissory note began to run from 1st January, it was later agreed that there should be no interest under the bond after 31st December, 1942. It is true that it was necessary to refer to the terms of the bond to find out the amount due, but after cancellation of the bond the obligation to pay that amount appears to me to have depended on the agreement and on it alone.

If that be so the Appellant cannot be assessable under Case IV. The source of the payments to her was not a security: it was an unsecured contractual obligation. It is true that the interest originally accrued from a security but it never became payable until the security had ceased to exist. I therefore agree that the cross-appeal should be dismissed.

The more difficult question is whether Case V applies. On the view which I have taken of the nature of the obligation to make the payments it was agreed that the source of the payments was a foreign possession. But it was argued for the Appellant that the payments were not income. It was, of course, admitted that if the Appellant had received payments of interest due under the bond while the bond still existed those payments would have been income. But then they would have been assessable under Case IV. So it was said that the sums actually received must be of a different character because if they are assessable at all it can only be under Case V ; and it was also argued that these sums cannot have retained their character of interest and they must be money which the Appellant obtained in consideration for giving up her right to receive the interest. The Appellant relied on certain cases where the taxpayer had given up a right to receive interest and had got instead a sum of money or money's worth and where the Crown's claim to tax the latter sum failed. But in these cases what the taxpayer had obtained was something different in character from the interest originally due to him. In the present case there was no such difference. The Appellant got the amount of money which had accrued as interest under the bond and nothing else. The substance of the transaction in so far as it affected the interest was simply a postponement of the date of payment, and the fact that the legal machinery by which this was done was the substitution of a new obligation for the old one does not appear to me to matter. Moreover, I do not think that the change from Case IV to Case V is important. That change might occur although the same obligation to pay interest continued unaltered. Interest payable under a foreign secured obligation is assessable under Case IV ; if the security is released or discharged Case IV no longer applies, and if the obligation remains in force as an unsecured obligation payments under it must then be assessed under Case V. So I am unable to see how anything that occurred in this case can be held to have changed the nature of the sums payable to the Appellant from interest or income to anything else, and I agree that the appeal should be dismissed. I should add that if I had taken the other view about the nature and legal effect of the agreement which the Appellant made with the company in 1942 I would have reached the same conclusion.

Questions put :

Lilley v. *Harrison* (*Inspector of Taxes*)

That the Order appealed from be reversed.

The Not Contents have it.

That the Order appealed from be affirmed and the appeal dismissed with costs.

The Contents have it.

Harrison (*Inspector of Taxes*) v. *Lilley*

That the Order appealed from be reversed.

The Not Contents have it.

That the Order appealed from be affirmed and the appeal dismissed.

The Contents have it.

That the Respondent do pay the Appellant his costs in this House.

The Contents have it.

[Solicitors:— Herbert Smith & Co. ; Solicitor of Inland Revenue.]

(17324) Wt. 3432—A198 K44 1/53 D.L.