STUDIES IN THE HISTORY OF TAX LAW

VOLUME 4

EDITED BY JOHN TILEY

Studies in the History of Tax Law

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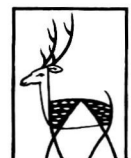
John Tiley



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STUDIES IN THE HISTORY OF TAX LAW

This work contains the full text of the papers presented at the fourth Tax Law History Conference in July 2008. The Conference was organised by the Cambridge Law Faculty's Centre for Tax Law.

The matters discussed are broad and include the extent to which charges levied by the Court of Wards were seen as taxes, the seventeenth-century poll tax, traders, the excise in early nineteenth century England and the right of the Crown's right to elect between different heads of charge to income tax. There are also chapters on taxation in the reign of King John and stamp duties in the eighteenth century.

International tax matters include a history of company residence and a paper on the first UK–Australia Double Tax Agreement. Papers concentrating on other countries include papers on the history of income tax in Malta (1641–1949), the history of land tax in Australia, the history of the legal definition of charity and its application to tax law and a paper on the psychology of taxation as shown by the 1936 US Election.

Preface

These papers were given in July 2008 at the fourth Tax Law History Conference organised by the Centre for Tax Law, which is part of the Law Faculty of the University of Cambridge. The importance of understanding the history of our system, not least our recent history, has never been greater. We are very happy that our contributing authors have provided us with so rich and diverse a range of materials and at such a high level, and that they are being made available in this published form, maintaining the very high standards our publishers set themselves.

We were blessed with wonderful summer sunshine. The buildings and grounds of Lucy Cavendish College provided an ideal setting. We acknowledge once again the support of the Chartered Institute of Taxation.

As ever, the papers were followed by discussions in out and out of the formal proceedings. It remains for me to thank those who gave papers or participated in other ways in what is becoming an important part of the academic tax law life in the United Kingdom. Already this event is known as Tax Law History IV; Tax Law History V is scheduled for July 2010.

One again, sincere thanks go also Christine Houghton and all the staff of Lucy Cavendish College, who made us so welcome, and to the President and Fellows of the college for allowing us to stay in their college.

Finally, thanks go to Richard Hart and his editorial team for taking this publishing project on and, in particular, to Mel Hamill, the Managing Editor, for all her hard work.

Cambridge
January 2010

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Part I

Great Britain and United Kingdom Tax History

1

The Crown Option

RICHARD THOMAS

This paper will form part of the 'deep structure' of HM Revenue & Customs' (HMRC's) Life Assurance Manual: an account of the historical development of the taxation of life assurance business without which those coming anew to the subject tend to flounder. Accordingly it covers some matters not wholly germane to the Crown Option, but which may nevertheless be of interest.

It is also to some extent work in progress (rather than stock in hand).

If a tax authority put forward, in relation to a particular type of business, that it proposed:

—to charge tax on the profits of that business in accordance with one of two alternative bases (basis A and basis B) to be chosen afresh each year at the tax authority's choice;
—that there would be no appeal against the use of the chosen basis;
—that if, after applying basis A, the tax authority chose basis B, any losses or other tax attributes falling to be carried forward under basis A would be irrevocably lost even if basis A were chosen again in the future, and vice versa;
—that if a company was on basis A but showed that basis B produced a loss it could still use that loss; and
—(after 112 years) that if basis A were chosen but basis B would show a greater profit, basis A could be adjusted to give the same result as basis B,

the proposal might well run into some problems in seeking to gain acceptance, and it might well be thought to fall foul of Adam Smith's tests of a good tax system.

Nonetheless, this in essence is the way that UK tax law has applied to the life assurance business of insurance companies. The 'Crown Option' was the description given by practitioners of the mysteries of life assurance company taxation to the Inland Revenue's ability to choose which of alternative bases of taxation might apply. Although the Crown Option related very substantially to the taxation of life assurance business, it was not in

fact confined to that business but could be applied to any financial trade; however, over the years most of the discussion and most of the argument has involved the life assurance aspect of it. The need for, and the effect of, the non-life assurance part of the Crown Option disappeared for all intents and purposes in 1996.

The life assurance Crown Option was finally put to rest by Schedule 8 to the Finance Act 2007. This paper sets out the history of the Crown Option and seeks to explain why it was finally removed from the Statute Book following a long period of rest and a sudden late revival in health; and also why the theoretical inequity of it was substantially tempered in practice.

THE BACKGROUND: THE SCHEDULAR SYSTEM

An examination of section 1(1) of the Income and Corporation Taxes Act 1988, which says 'Income Tax shall be charged in accordance with the provisions of the Income Tax Acts in respect of all property, profits or gains respectively described or comprised in the Schedules A, B, C, D, E and F . . .', will show that there has been little real change compared with section I of 43 George III, c 122 (the Income Tax Act 1803), which provides 'that, during the term herein mentioned, there shall be raised, levied, collected, and paid, throughout Great Britain the several duties and contributions in the Schedules contained in this Act, marked (A.) (B.) (C.) (D.) and (E.)'.

Each of the Schedules sets out a separate subject matter of taxation, and in the Act of 1803 sets out an elaborate machinery in relation to each separate Schedule for the calculation of the amount of tax and in particular its assessment and collection. It has long been established that the Schedules are mutually exclusive (see *Salisbury House Estate Ltd v Fry*[1]), even where they themselves do not explicitly so provide. However proudly an activity of letting land wears the badges of trade, the charge to tax is under Schedule A (income from land) and not under Schedule D (profits from trades).

Within some of the Schedules, notably Schedules A and D, there were further distinctions drawn according to the particular nature of the type of income within the general head of the Schedule. The main purpose for setting out separate types of income—or 'Cases', as they were specifically referred to in Schedule D—was to allow different methods of computation of the tax base in relation to each type of income and the method by which the income is assessed and charged to tax.

[1] 15 TC 266, [1930] AC 432.

In section 84 of the Act of 1803 the general scope of the charge under Schedule (D.) is set out, namely:

> upon the annual Profits or Gains arising or accruing to any Person or Persons residing in Great Britain from any Kind of Property whatever; whether situate in Great Britain or elsewhere, or from any Profession, Trade or Vocation whether the same shall respectively be carried on in Great Britain or elsewhere . . .
>
> And upon the annual Profits or Gains arising or accruing to any Person or Persons whatever, whether subjects of His Majesty or not, although not resident within Great Britain, from any Property whatever in Great Britain, or any Profession, Trade, Employment or Vocation exercised in Great Britain . . .

The first three paragraphs of Schedule (D.) in section 84 are followed by a heading 'Rules for ascertaining the said last mentioned Duties in the particular Cases herein mentioned'. There is then set out the six cases—for the purposes of this paper we are concerned only with the first, third, fourth and fifth cases:

—the first case is duties to be charged in respect of any trade or manufacture;
—the third case is the duty to be charged in respect of property of an uncertain value, not charged in Schedule (A.) (by 1842 the third case explicitly included any interest which was not annual interest);
—the fourth case is the duty to be charged in respect of interest arising from securities in Ireland or in the British Plantations in America, or in any other of His Majesty's dominions out of Great Britain and foreign securities;
—the fifth case is the duty to be charged in respect of possessions in Ireland or in the British Plantations in America, or in any other of His Majesty's dominions out of Great Britain and foreign possessions.

Nomenclature can become very confused in this area. In the rest of this paper tax 'on the basis of profits' and similar expressions means tax charged in accordance with the first case, or Case I, and tax on 'interest' or 'investment income' means tax charged in accordance with the third, fourth or fifth cases, or Cases III, IV and V.

THE BUSINESS OF LIFE ASSURANCE AND OTHER FINANCIAL TRADES, AND WHY INCOME MAY FALL WITHIN MORE THAN ONE CASE

In most trades the trader buys something and then sells it to a customer. To be able to do that, the trader requires capital. Having acquired that capital, the trader does not simply invest it to produce interest but employs it, for example, to buy the things which it wishes to sell.

Looking at the trade of a bank, that pattern can still be seen: a bank borrows money from its depositors to enable it to lend that money to borrowers. An insurance company says to its customers that it will provide them (perhaps) with something, but that may be a long time in the future; however, they must pay for it now. No rational person is going to pay £X today in order to recover £X in 20 years' time, so the price of getting £X in 20 years' time is likely to be heavily discounted. The life insurance company therefore has the job of making this heavily discounted receipt—the premium—become the much larger amount that it will need to pay to the customer. To do that, it clearly needs to invest a large part of the premiums it receives, and it is evident that without the interest from investing premiums the business of life assurance in particular could not survive. Life insurance is about the clearest case imaginable of income from investments being 'integral' to the carrying on of a trade.

Such investments do not necessarily have to be in the UK. Many insurance companies in the nineteenth century were active in the dominions and colonies, and in those places it was normal, if not required by the domestic authorities, for the company to invest in locally situated assets. A company carrying on life assurance business was then quite likely to have both income falling within Case III of Schedule D in the form of untaxed interest (interest from which tax was deducted did not fall within Case III) and income within Cases IV and V if it had foreign operations.

At the same time it undoubtedly carried on a trade, and income within Cases III, IV and V was undoubtedly trading income. It therefore also seemingly fell, in the wording of the Cases, to be included in a computation made in accordance with the rules of Case I of Schedule D.

This particular issue was not confined solely to companies carrying on life assurance business: it also applied to companies carrying on non-life business. In fact, in the nineteenth and much of the twentieth centuries, most insurance companies carried on both life and non-life business in the same company—so called 'composite' companies. Insurance was one of the first types of activity to be regulated and for which there was a requirement to produce audited accounts.[2] The provisions of the Life Assurance Companies Act 1870,[3] the first of the Acts regulating insurance, show that there were up to five categories of insurance business which were treated separately for regulatory purposes and for which separate funds were required. In addition to life assurance business, which included annuity business, there was bond investment business (a form of long-term insurance not involving any contingency on human life and known now as

[2] Railway companies incorporated in Great Britain were required by the Regulation of Railways Act 1868 (31 & 32 Vict, c 119) to do much the same. Some of the regulations look distinctly odd today: s 20 requires a company to provide smoking accommodation for each class of carriage (but the Metropolitan Railway was exempt).

[3] 33 & 34 Vict (c 61).

capital redemption business), together with classes of what is now general insurance business, fire, marine and property insurance.

It is true to say that, in relation to the classes of general insurance business, the requirements to hold investments as an integral part of the business were less than in life assurance business, but there was still a likelihood of investments being needed to be held to meet liabilities in that business, especially where the liabilities were of a longer term nature.

In addition to insurance business, banks also carried on a trade within Case I of Schedule D and received investment income, particularly interest which was not annual interest, in the course of that trade. Other forms of institution lending money by way of trade could also receive investment income, particularly where that trade was the lending of money with interest. Such lending by a bank or similar concern could also be outside the UK and so give rise to income falling within Case IV or V, as well as being a trading receipt.

In addition to income chargeable by assessment under Cases III, IV or V of Schedule D, a financial concern of the type mentioned above would also often receive very substantial amounts of taxed interest, interest from which the payer deducted tax, and dividends treated as having been paid out of taxed income. The treatment of the interest and dividends was somewhat different. Where a company received taxed interest or dividends in the course of a trade, they were excluded from any computation of trading profits under Case I on the basis that they had already been charged to tax and therefore could not be charged again by way of direct assessment.

As a result, where a financial concern generated substantial amounts of taxed interest and dividends, it was quite likely that, even though on any basis of accounts drawn up in accordance with commercial practice there would be a profit, there might well be a substantial loss under Case I of Schedule D.

In such a case there was of course no Case I profit, so where there were any significant amounts of income chargeable under Cases III, IV or V more tax was likely to be generated overall if there was a charge to tax on the Case III, IV or V income than if they had been included in the Case I computation of profit. It should be remembered that there was no facility to claim back any tax on taxed interest and dividends in excess of the amount needed to 'frank' any charge under Case I.

Income under Cases IV and V was, until 1915, universally charged to tax on the remittance basis. However, the remittance basis did not apply to a trade charged to tax under Case I of Schedule D, so where a trading company had substantial amounts of income chargeable under Cases IV and V it might suffer a higher overall liability if that income could instead be included in a charge on profits under Case I on an arising basis.