Studies in the History of Tax Law

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Edited by

PROFESSOR JOHN TILEY

Director of the Centre for Tax Law
University of Cambridge

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This volume is dedicated by the contributors to
LOUISE TEE
Fellow of Lucy Cavendish College, Cambridge,
with grateful thanks

Preface

Over two perfect English September days in 2002, a group of some 40 interested people gathered together for the first Tax Law History Conference organised by the Centre for Tax Law which is part of the Law Faculty of the University of Cambridge. Our days were passed in the beautiful surroundings of Lucy Cavendish College and the air was heavy with the scents of a Cambridge Edwardian garden in late summer. No less perfect and no less intoxicating were the technical discussions as we sat and listened to the speakers and talked among ourselves. The volume which follows is a collection of the papers delivered over those two days which triggered those discussions. For those who were present it will, I hope, provide a wonderful souvenir.

For those who were not present I hope it will provide an indication of the range of material waiting to be thought about and written about. The story of taxation is, as every school pupil used to know, central to the story of our constitution and yet there is so much more to this story than the execution of kings or other seventeenth century struggles. It is of course true that there is much to be written about tax in the current day and the lack of much good legal scholarship on current issues from our universities is to be much regretted. Yet, not least in order to prevent governments from trying to reinvent the wheel, there is also a need to record the history of our subject. Some of that history may be ancient but other parts will be relatively modern; both aspects are shown in the range of essays in this book. There are many important parts of our history which are not represented in our book at all – but one which I particularly regret is to be found in the recollection of those who practised tax in the 1940s, 1950s or 1960s. We like to think of oral history as involving quaint folk reminiscing about the good/bad old days; yet if the technique is sound for social history it must also be valid for the institutional and technical history of our subject. One senses again and again how much there is to be done.

As will be seen from the table of contents, we were a mixed crew, for the most part economists, historians and lawyers, but with participants drawn from legal practice and the Department of Inland Revenue as well as from academia. We were also a diverse group in terms of nationality.

The conference was put together by a team led by Louise Tee, then Fellow in Law and Senior Tutor of Lucy Cavendish College and to whom, by unanimous wish of the contributors, this volume is dedicated. It was

Louise's idea to solicit papers for this our first gathering broadly rather than by theme. The result is a range of materials which truly merits the word 'diverse' – diverse by period, diverse by topic and diverse by discipline. We were delighted and surprised by the number of people who expressed an interest in giving papers and trust that we have been forgiven by those we had to turn away. A second conference is to be held – also in Lucy Cavendish College – in July 2004.

My role as editor is one which I have taken very lightly, trusting those in different disciplines to follow their own customs. So I have left Martin Daunton's historian's way of citing a decided law case (p. 10) rather than insisting on a lawyer's habit (contrast the same case at p. 92). I also spent quite some time wondering whether to require that all case names should be italicised, before concluding that Philip Ridd's practice of having some in italics and others simply underlined worked rather well in the context of his material. Thus the academic's mind was stretched and pulled over things that really mattered.

It remains for me as Director of the Centre to express my thanks – both personally and officially – to all those who made those days the delight they were. My initial salvo of thanks goes, first, to all those who gave of their time to attend the conference and so made it the happy event it was, secondly, to all those who gave papers and thus a focus for our thoughts and words. Thanks go, thirdly, to Christine Houghton and all the staff of Lucy Cavendish College who made us so welcome and, finally for now, to the President and Fellows of the college for allowing us to stay in their college. 'Lucy', as it is generally known, is one of the newer and therefore more comfortable constituent colleges of the University. It also has a very distinct role in the University, being the only college to concentrate exclusively on the admission of mature women students.

My second salvo of thanks is written under a grey late November sky and expresses my appreciation to Richard Hart and his editorial team for taking this publishing project on. Our thanks go to Richard for his vision and to April Boffin as the Publishing Editor for all the hard work.

My final set of thanks goes to those who have supported the centre. In the context of the conference, and so of this volume, this means the Chartered Institute of Taxation who have provided invaluable corn seed support. We are also grateful to others for their support for the Centre and its activities, notably the IFA Congress Trustees and, most notably of all, KPMG who have funded a lectureship in tax law held by Dr Peter Harris, Fellow of Churchill College, who will be contributing to our second volume.

John Tiley

Cambridge
November 2003

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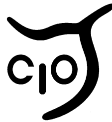

Contents

Contributors **xiii**

PART 1 VICTORIAN AND MODERN

1. What is Income? 3
Martin Daunton
2. Taxing Foreign Income from Pitt to the Tax Law Rewrite – The Decline of the Remittance Basis 15
John Avery Jones, CBE
3. Income Tax Tribunals: Their Influence and Place in the Victorian Legal System 57
Chantal Stebbings
4. Aspects of Schedule A 81
John Tiley

PART 2 TWENTIETH CENTURY PROBLEMS

5. Excess Profits Duty 101
Philip Ridd
6. Deliberations over Taxing Capital Gains – The Position up to 1955 133
David Stopforth
7. The Evolution of UK Tax Legislation for Employee Share Ownership Plans 147
Peter Casson
8. What's in a Name? 177
JDB Oliver

PART 3 DEEP HISTORY

9. John Lackland: A Fiscal Re-evaluation 201
Jane Frecknall Hughes and Lynne Oats
10. Estate Planning in Early-Modern England: 'Having' in the Statute of Wills 1540 227
Neil Jones

11. Stamp Duty, Propaganda and the French Revolutionary and Napoleonic Wars 243
Lynne Oats and Pauline Sadler

12. Slave Taxes 263
Kevin Outterson

PART 4 COMPARISONS

13. The Chicken or the Egg? A Historical Review of the Influence of Tax Administration on the Development of Income Tax Law in Australia 285
Professor Cynthia Coleman and Dr Margaret McKerchar

14. The Long and Winding Road: A Century of Centralisation in Australian Tax 313
Rodney Fisher and Jacqueline McManus

15. Formalism and Israeli Anti-Avoidance Doctrines in the 1950s and 1960s 339
Assaf Likhovski

16. Tax Reform in Hong Kong in the 1970s: Sincere Failure or Successful Charade? 379
Michael Littlewood

Contributors

Dr John Avery Jones, CBE, is a Special Commissioner and Visiting Professor, London School of Economics.

Dr Peter Casson is in the School of Management at the University of Southampton.

Cynthia Coleman is Associate Professor of Taxation at the University of Sydney and Editor of *Australian Tax Forum*.

Martin Daunton is Professor of Economic History, University of Cambridge.

Rodney Fisher is Senior Lecturer at ATAX in the Faculty of Law, University of New South Wales.

Dr Jane Frecknall Hughes is at Leeds University Business School.

Dr Neil Jones is a Fellow, Magdalene College, Cambridge, and a University Lecturer in Law.

Dr Assaf Likhovski is a Senior Lecturer in the Faculty of Law at Tel Aviv University.

Dr Michael Littlewood is Professor, School of Law, University of Hong Kong.

Dr Margaret McKerchar is in the Faculty of Rural Management at the University of Sydney.

Jacqueline McManus is at ATAX, University of New South Wales.

Dr Lynne Oats is Lecturer in Accounting and Taxation at Warwick Business School and Visiting Research Fellow, Curtin University of Technology.

David Oliver is an assistant director at the Centre for Tax Law, University of Cambridge, and Visiting Professor of International Tax at the London School of Economics and Political Science.

Kevin Outterson is Associate Professor of Law at West Virginia University.

Philip Ridd is the Solicitor of Inland Revenue.

Dr Pauline Sadler is Senior Lecturer, Curtin University of Technology; Honorary Research Fellow, University College, London.

Chantal Stebbings is Professor of Law and Legal History at the University of Exeter.

David Stopforth is Professor of Revenue Law, Department of Accounting Finance and Law, University of Stirling.

John Tiley is a Fellow of Queens' College, Cambridge, and Professor of Tax Law at the University of Cambridge.

Part 1

Victorian and Modern

1

What is Income?

MARTIN DAUNTON[1]

ABSTRACT

IT IS USUALLY assumed that the British tax regime lacked any systematic definition of income. However, a lack of precision does not mean that the definition of income was ignored. The aim of this paper is to explore the different and contested assumptions informing debates over income. The income tax of 1842 was subdivided into schedules, each of which implied different assumptions about income, whether calculated over the previous year or averaged over a number of years, based on actual income or determined by some external measure. Different forms of income were considered by some commentators to be more susceptible to taxation, such as 'spontaneous' or 'unearned' income from land in comparison with 'industrious' or 'earned' income from trade. Others feared that differentiation between forms of income would compromise political stability by inserting class conflict into the tax code. Unlike in the United States income tax, capital gains were not defined as income in Britain until 1965. Unlike the United States corporation tax of 1909, and with the exception of the First World War and postwar reconstruction, the income of British companies was not considered to be separately taxable until after the Second World War. The extent to which gross profits could be adjusted to take account of depreciation and obsolescence was problematic. Similarly, questions arose concerning the extent to which an individual's liability to income tax could be reduced to take account of savings, family responsibilities and charitable donations. The paper explores the political, social and cultural contexts for the debates and decisions, and seeks to explain the emergence of a peculiarly British approach to income.

In his discussion of concepts of taxable income in different countries, P. H. Wueller remarked that there was no systematic concept of income

[1] This essay draws on my *Trusting Leviathan: The Politics of Taxation in Britain, 1799–1914* (Cambridge 2001) and *Just Taxes: The Politics of Taxation in Britain, 1914–1979* (Cambridge, 2002).

in Britain, and that economists simply accepted the approach of the Inland Revenue.[2] As Wueller pointed out, the definition adopted by the Royal Commission on the Income Tax at the end of the First World War – the first major overview of the tax since its reintroduction in 1842 – was no more than a tautology. 'If there is any class of income', the Report concluded, 'that does not fall within the words that impose the charge in any one of the Schedules, that class of income is not within the scope of the Income Tax'. In other words, income was that on which the income tax was levied.[3] In 1901, Lord Macnaghten took exactly the same line. 'Income tax, if I may be pardoned for saying so', he remarked, 'is a tax on income. It is not meant to be a tax on anything else.'[4] But how accurate are these commonsensical claims? In reality, the definition of income was rigorously contested in the nineteenth and twentieth centuries. The outcome was not a systematic definition, but that is not really the point. Rather, we should ask what cultural, political and ideolog- ical assumptions – often unarticulated and ill-defined – underlay the approach to income of lawyers, economists, civil servants and politicians.

The first point to ask is: what did the income tax schedules define as being income, based on what assumptions and exclusions? John Tiley makes the important point that the principles of the tax system were administrative, the values of the plumber and not of Pericles; and that the result was a rag-bag of taxes.[5] The approach adopted by the tax authorities and the government was to ask: what works in an effective way? When William Pitt the younger introduced the income tax in 1799, the tax authorities tried to produce an estimate of income from all sources in a single measure. It did not work as well as the schedular system of Addington which was substituted in 1803. The difference in yield was considerable: under the first system, a rate of 2s in £ produced £5.6m in 1801; under the schedular system, a rate of 1s produced £5.3m in 1803.[6] The use of schedules meant that compliance and collection were much easier, for income from different sources could be collected by the most appropriate method. Furthermore, the effective rate of the tax varied, for income was measured in different ways under each schedule.

[2] P. H. Wueller, 'Concepts of taxable income. I, The German contribution', *Political Science Quarterly* 53 (1938), p. 85.
[3] PP 1920 XVIII, *Report of the Royal Commission on the Income Tax*, p. 108.
[4] *Law Reports 1901. House of Lords, Judicial Committee of the Privy Council* (London, 1901), HL(E) 1900, London County Council and others and Attorney General, p. 35.
[5] This volume, pp. 86.
[6] PP 1852 IX, *First Report from the Select Committee on Income and Property Tax*, C. Pressley of the Inland Revenue, Q 367.

INCOME TAX SCHEDULES: DEFINITION OF INCOME AND METHOD OF COLLECTION

Schedule A (Land and Houses)

Tax was levied on gross income until 1894, when an allowance was given for repairs; it was paid at source by deduction from the rent paid by tenants. Prior to 1894, the effective rate was higher than the nominal rate.

Schedule B (Occupation of Land)

Payment at source was impossible, for the income depended on receipts from crops over the year, and the amount spent on seeds, animals, wages and other inputs. Farmers were unlikely to have good records to make assessment realistic, so in 1842 it was assumed that profits were half of the rent paid in England and a third in Scotland. In 1851, farmers had the option to pay tax on the actual profits, if these were lower. The effective rate of tax was below the nominal rate.

Schedule C (Profits from Government Stock and Dividends)

Tax on this income was deducted at source, and the effective and nominal rates were the same. There was no scope for evasion or avoidance.

Schedule D (Profits from Trade, Commerce and Professions)

For similar reasons to schedule B, collection at source was impossible, and there was no feasible indicator of profits as in the case of farming. The amount of income was assessed by lay commissioners and assessors, and the Inland Revenue assumed that it was under-returned by about 20 per cent. Officials were willing to condone a degree of evasion for a reasonable level of compliance. The effective rate was below the nominal rate.

Schedule E (Salaries and Pensions from Office)

Tax was deducted at source. The effective rate was the same as the nominal rate.

Source: A. Hope-Jones, *Income Tax in the Napoleonic Wars* (Cambridge, 1939), pp. 20–1; PP 1870 XX, *Report of the Commissioners of Inland Revenue on the duties under their management for the years 1856 to 1869 inclusive*, vol. 1, pp. 326, 328.

The application of these schedules created difficulties of definition. Did salaries from employment in a private firm fall under schedules E or D; were mines to be classified under schedules A or D; and did shares in a private company fall under schedules C or D? The decision affected what could be set against profit or income, and whether the actual profit of the year or the average of several years was taken.[7] As a result, the Inland Revenue and the courts had to deal with complicated disputes over the exact nature of certain forms of enterprise and employment. Lord Macnaghten and the Royal Commission on the Income Tax were being somewhat disingenuous.

Of course, administrative convenience was a leading constraint on the definition of income in the schedules: the basic concern was ease of collection. Nevertheless, there were important underlying assumptions and conflicts of definition that are missed by Wueller. First, the words in the schedules were contested, with very different meanings applied by the officials of the Inland Revenue and the taxpayers and their advisers, which needed to be resolved by the courts. Second, there were silences in the legislation so that certain forms of income were not taxed at all. A consideration of these points will tease out some important assumptions that underlay the definition of income, despite the absence of a formally stated set of principles.

In the case of land, was a ground landlord of an urban estate – say the Duke of Bedford in Bloomsbury or the Duke of Manchester in Mayfair – who paid tax under schedule A liable for the reversion of the land and the houses erected on it at the end of a 99 year lease? A ground landlord paid tax on the annual flow of ground rents, which were fairly modest. Much of the benefit came at the end of the lease when the land was repossessed at improved values, plus the houses erected on the land by the builders. This reversionary value was not taxed as part of the income received, which became a major political issue. To radical Liberals, the energy and investments of the community led to an increase in the value of the land, and the landowner was a parasite on productive capital. In the opinion of the radicals, landowners should therefore be taxed more heavily. The defenders of the landowners responded that they were already taxed more heavily through the incidence of local rates which fell only on houses and land; and they also paid the land tax. The radical response was that the ultimate incidence of the rates fell mainly on enterprising occupiers of property and not on parasitical owners who were therefore under taxed. The debate over these issues was highly complex and of considerable political consequence. During the era of Gladstonian Liberalism, the leadership of the party was anxious that the land question did not intrude into national politics and set one class against another. Gladstone argued that the different forms of tax on land resulted in balance in the incidence of taxation. In the Edwardian

[7] The matter was discussed by PP 1920 XVIII, Report of the Royal Commission on the Income Tax.

period, the leadership of the party moved towards the radical position. In his people's budget of 1909 David Lloyd George introduced a new set of taxes on land values, so provoking a major constitutional crisis. The status of income from land was a major political issue.[8]

The definition of income involved not only the increased capital value of land, but also appreciation of stocks and shares, and their realisation. Were capital gains to be treated as income? According to the act of 1842 restoring the income tax, schedule D covered the 'annual profits or gains' from trade, commerce and the professions, a phrase taken to mean annually recurring and reasonably secure income. As a result, casual profits or one-off sums were excluded. The implication was that a trader who made his living from buying and selling commodities would pay tax on the profits. However, if an individual made an occasional profit from selling shares or a stockpile of goods, the income was not an annual profit and it was not taxed. The distinction rested on the principle that the tax should fall on the fruit of the tree (income) and not on the tree (capital).[9]

Of course, income and capital were not always so easily distinguished and the lord chancellor struggled with a definition in 1903. As he pointed out, the income tax acts were never intended to tax capital as income, but he admitted that 'I do not think it is a matter on which one can dogmatise very clearly…. The income tax is not and cannot be, I suppose from the nature of things, cast upon absolutely logical lines, and to justify the exaction of the tax the things taxed must have been specifically made the subject of taxation'.[10] Capital gains were not specifically defined as income in the legislation, but it might still have been possible to argue that they amounted to an annual profit or gain. After all, 'annual' could be taken to mean the income of the particular year, and not an annual recurring income. Officials at the Inland Revenue chose not to develop this line of reasoning, and they were clearly of the view that capital gains should *not* be defined as income. They moved from the principle of administrative convenience to a normative position, arguing that capital gains should not be included within the definition of income and specifically made the subject of taxation. Economists in the late 1940s, such as John Hicks, argued that capital gains on stocks and shares offered a way of avoiding high levels of income tax on dividends.[11] A number of Conservative politicians also saw the need

[8] The land question is discussed in detail in A. Offer, *Property and Politics, 1870–1914: Landownership, Law, Ideology and Urban Development in England* (Cambridge, 1981); see also D. Reeder, 'The politics of urban leasehold in late Victorian England', International Review of Social History 6 (1961).

[9] S. 1 Income Tax Act, 1842, 5 and 6 Vict c. 35; see also L. H. Seltzler, The Nature and Tax Treatment of Capital Gains and Losses (National Bureau of Economic Research, New York, 1951), pp. 1–16, 256–62.

[10] The Law Reports 1903. House of Lords, Judicial Committee of the Privy Council (London, 1903), HL (E) 1903, Secretary of State in Council of India and Sir Andrew Scobie, pp. 302–3

[11] J. R. Hicks, 'The empty economy', Lloyd's Bank Review ns 5 (1947).

for a tax on capital gains, to reduce criticisms of speculative fortunes and to respond to the sensitivities of salaried middle class families who did not have the same opportunity of avoiding tax. After all, the US tax code had defined capital gains as part of income from its inception, and it was not necessarily a socialist device to attack the private market.[12]

Resistance to taxation of capital gains was based on the concept of *res* which arose from the law of trusts. What were trustees expected to preserve: the income of the trust (that is, the fruit) or the capital of the trust (the tree)? The courts held that the tree or *res* should be protected. If a trust held £1,000 in stocks or a piece of land, and their value rose to £1,200, the trustees could not sell stocks or land to realise £200 and spend it as income. Similarly, if the value of the stocks or land fell to £800, the trust had no obligation to divert income to protect the value of the *res* or fund from which income was drawn. Above all, the use of settlements for aristocratic estates led to considerable legal discussion of the distinction between what constituted the income of the estate, which was available to the life tenant or other beneficiary to spend, and what constituted the principal or capital to be conserved for future generations. The life tenant had to be prevented from cutting down the trees on the estate and taking the proceeds as income, so leaving his heirs with a denuded estate. Income *was* considered and defined, and the assumptions underlying these debates were then transposed to the income tax. Of course, aristocratic settlements were not a consideration in the United States, where the law was shaped by different considerations. The contentious issue at the turn of the nineteenth and twentieth centuries was the potential of business corporations to distort society, threatening the world of independent farmers, traders and small businessmen. Hostility to corporations meant that they were subjected to a separate corporation tax in 1909, prior to the introduction of the income tax in 1913, and the Supreme Court also ruled that realised capital gains counted as income.[13]

In the case of Britain, the status of the income of companies raised another definitional problem. Did companies have an independent taxable identity, receiving income apart from the dividends paid to their shareholders or were they simply a collection of individuals, each with a separate liability to tax? Companies paid income tax on their profits, which was set against the tax

[12] For example, David Eccles (Public Record Office, T171/457, David Eccles to prime minister, 1 Sept. 1955); W. W. Brudno and L. D. Hollman, 'The taxation of capital gains in the United States and the United Kingdom', British Tax Review (1985), 26–48.

[13] N. Isaacs, 'Principal: quantum or res', Harvard Law Review 46 (1932–3); R. Lachs, 'Income tax on capital profits', Modern Law Review 6 (1942–3); Seltzer, Nature and Tax Treatment of Capital Gains, pp. 25–46, 257; J. D. Buenker, The Income Tax and the Progressive Era (New York and London, 1985); W. W. Brownlee, *Federal Taxation in America: A Short History* (Cambridge, 1996), pp. 36–43, 46; H.B. Spaulding, The Income Tax in Great Britain and the United States (London, 1927), pp. 35, 86–93; K. K. Kennan, *Income Taxation: Methods and Results in Various Countries* (Milwaukee, 1910), pp. 280–2.

liability of their shareholders. Under schedule E, companies withheld tax on dividends at the standard rate and shareholders were paid net of tax. If a shareholder fell below the tax threshold, the tax was then reclaimed; if the shareholder was liable to the higher rate of surtax after 1909, an additional payment was made. Companies were a device for withholding tax at source, and were not taxed in their own right. The first breach in this principle was the excess profits tax introduced during the First World War. It was continued at the end of the war, when it was supplemented by a new corporation tax on the lines of the American corporation tax. Both taxes were abolished by 1924, with cross-party consensus between Stanley Baldwin and Philip Snowden that companies should not be separately taxed. The assumption of the Inland Revenue and of politicians, until the Second World War, was that companies did not have any separate personality or taxable capacity apart from individuals who held the shares.[14]

On what basis should profits of businesses be calculated? The crucial consideration was what allowance should be made for depreciation and obsolescence. The income tax legislation allowed the three-year average of actual expenditure on repairs of premises or the supply and repair of implements to be set against tax, but not depreciation and obsolescence. As a result, the cost of mending a broken cog-wheel could be set against profits, but not the obsolescence of the entire machine. In 1905, the chairman of the Inland Revenue admitted the flaw in the acts of 1842 and 1853 where the income tax was defined as a tax on profits. In his view, it was 'incontrovertible' that the profit of a coal mine costing £100,000 to commence, and producing a profit of £10,000 a year for 40 years, was £300,000 (that is £400,000 gross profit less £100,000 depreciation).[15] But the acts assumed the tax was a temporary measure, and therefore only took account of the short term. If the income tax were to be abolished, as Gladstone intended, how could the long-term depreciation of the asset be taken into consideration?

In practice, the term 'supply and repair' was interpreted more generously by local commissioners of the income tax, without legal sanction and without consistency. In 1878, the local commissioners were permitted by the Inland Revenue to 'allow such deduction as they may think just and reasonable as representing the diminished value by reason of wear and tear during the year of any machinery or plant'. But what was 'just and reasonable'?

[14] Kennan, Income Taxation, pp. 28–2; Spaulding, Income Tax, pp. 35–6, 86–93; G. S. A. Wheatcroft, 'The tax treatment of corporations and shareholders in the United States and Great Britain', British Tax Review (1961), pp. 41–61.

[15] PP 1905 XLIV, Departmental Committee on Income Tax, appendix III, 'Memorandum submitted by Sir H. Primrose: c. Depreciation of assets charged to capital account', pp. 258–63. On the difficulties faced by coal companies in defining their profit, see M. W. Flinn, *The History of the British Coal Industry, II, 1700–1830: The Industrial Revolution* (Oxford, 1984), pp. 314–5; R. Church, *The History of the British Coal Industry, III, 1830–1913: Victorian Pre-eminence* (Oxford, 1986), p. 512.

When the matter was tested in the courts, a narrow interpretation was taken. In *Caledonian Railway Co v Banks*, 1880, the actual costs of repairing rolling stock were allowed; the depreciation of rolling stock which was in good repair and simply inefficient and in need of replacement was not allowed. The same point applied to coal mines. In the case of *Coltness Iron Co v Black*, the court took a view contrary to the chairman of the Inland Revenue: the only concern was the profit of one year at a time, and not the balance after taking account of the sinking costs. There are complex legal issues, but the reasoning of the courts and lawyers seemed puzzling to the business community. There was a growing tension between the courts' interpretation of what constituted profit and the assumptions of businessmen and accountants. This tension was worked out through the use of local discretion and even subterfuge. The Inland Revenue was willing to permit local commissioners to make allowances for obsolescence, on condition it was negotiated with a representative body of the trade in the district, and that the practice was not publicised. The result was local variation and inconsistency.[16]

The difficulty of defining profit and capital was repeated in the case of the local property rate as well as the income tax. The rate was levied on the annual letting value of real property, which posed the difficulty it could be assessed on railways, gas works or water undertakings. Was the value of the property to be measured by the profit derived from the concern, which would indicate how much someone would be willing to pay in rent? On the whole, the courts ruled that the actual profit of the concern was not the correct measure. The rent of a factory or shop could be established by the amount a prospective tenant would pay, and the same should be done for a gas works. Of course, this was difficult to measure for a gas works was of little value to alternative users. In the case of railways, another issue arose – how to allocate the rate between the parishes through which the line ran? A parish could view a railway company, owned by people from outside the parish, as a convenient source of revenue and the potential scale of the tax bill alarmed the companies. The solution was to treat the companies as an

[16] Reports of Tax Cases under the Act 37 Vict cap 16 and under the Taxes Management Act, vol. 1, 1875–1883 (London, 1884), Court of Exchequer, Scotland, Second Division, 1880, *Caledonian Railway Co v Banks*, pp. 487–501 and *Coltness Iron Co v Black*, in the Court of Exchequer, Scotland, 1879/80, pp. 287–324; Parliamentary Debates, 2nd ser 239, 4 April 1878, col. 552; PP 1905 XLIV, Departmental Committee on Income Tax, evidence of A. Chamberlain, Qq 1905, 1908–9, 1911–2, 1929 and Report, pp. 231–3; appendix III, 'Memorandum submitted by Sir H. Primrose: c. depreciation of assets charged to capital account', pp. 258–63; appendix IV, 'Statement showing the special rates of allowance for wear and tear of machinery and plant', p. 264; appendix V, 'Copy of letter from the chancellor of the Exchequer dated 28 May 1897 to the secretary of the Association of Chambers of Commerce on wear and tear of machinery', p. 265; PRO, T171/38, Finance Bill, 1913: Income tax, 12, schedule D, allowance for depreciation of machinery and plant; Seltzer, Nature and Tax Treatment of Capital Gains, pp. 256–7.

integrated concern, and to allocate the rates between the parishes in proportion to the amount of track passing through each parish – an approach resting on mutual consent rather than legislation.[17] As in the case of income tax, the courts were grappling with difficult issues of how to measure value and profit.

Not only did the definition of profits raise the issue of how far depreciation should be set against trading profits. It also posed the vexed question of whether an individual's savings should be set against income – a question of particular relevance to schedule D. Of course, Gladstone assumed that prudence and self-reliance were desirable, and he wished to encourage savings through the creation of the Post Office Savings Bank. He also believed that high levels of saving would lead to investment and economic growth. Nevertheless, he was firmly opposed to tax breaks on savings, with one exception. In his great budget of 1853, Gladstone was firmly opposed to differential taxation of income, a proposal attracting considerable support in the 1840s and 1850s. The case for differentiation was that the tax rate on 'spontaneous' income from land and bonds should be higher than on 'industrious' income from trade and industry. Spontaneous income continued in ill-health and retirement, and left a capital asset at death for the support of dependents. Industrious income was not available in illness or old age, and ceased completely on death. Consequently, the recipient of industrious income needed to set aside money in his active years to support himself and his dependents. The advocates of differential taxation therefore argued that the same income from the two sources had different values and should be differentially taxed. John Stuart Mill felt that taxation should ideally fall on any income that was consumed rather than saved; other commentators believed that all forms of income should be converted into capital values depending on their likely duration. In practice, the difficulties of establishing how much was set aside from industrious income, and the complexities of capitalisation, meant that the advocates of differentiation turned to a simple assumption of how much should be set aside, with a reduction of the tax on industrious incomes by a fixed proportion regardless of whether savings were actually made. This approach rested on allocating different income tax schedules as either industrious or spontaneous, which rested on particular assumptions about the nature of income. The leading advocate of differentiation, the London merchant and financier John Gellibrand Hubbard, was a staunch supporter of family firms and partnerships. Although they might be engaged in the same line of business with similar risks, he assumed that shares held in joint-stock

[17] The vexed issue of valuation for rates will be discussed in the Cambridge PhD thesis of Sally Brierley; see W. C. Ryde, *On Rating* (London, 1912). On railways, see R.W. Kostal, *Law and English Railway Capitalism*, 1825–1875 (Oxford, 1994), pp. 221–5, 242–8.

companies produced spontaneous incomes and should therefore pay a higher rate of tax than profits from family businesses.[18]

Gladstone was firmly opposed to the adoption of differentiation, on three main grounds. First, it would use the tax system to define economic interests, which would corrupt the tax system and create social conflict. Second, he feared it would be the thin end of the wedge leading to graduated taxation, which he feared as a very real threat to incentives and prosperity. Third, he believed that differentiation was unnecessary, given the fact that real property already paid other forms of tax such as the local rates and the land tax. The one exception he allowed in 1853 was tax relief on life insurance premiums, which was a sop to the proponents of differentiation.[19] When differentiation was eventually adopted in 1907, the political circumstances had changed. Now, the attack on 'unearned' income – a significant change in terminology from 'spontaneous' income – was a rallying cry for the radical Liberals, and it offered a way of appealing to workers who might desert for the new Labour party. It was related to a wider discourse on 'socially created wealth', the extent to which income from land rose as a result of the enterprise of society rather than the merit of the landowners. Although the case for differentiation meshed with radical perceptions or new Liberalism, it was retained by Conservative governments until it was eventually repealed in 1984, when encouragement was given to savings through tax breaks. As some critics pointed out, a higher level of taxation of income from savings and investments could be criticised for harming widows or the elderly living on small sums saved out of the earned incomes of themselves and their husbands. Nevertheless, interwar Chancellors in the Conservative governments retained differential taxation, preferring to give tax breaks to the recipients of modest earned incomes, and above all to family men. The Conservatives could then portray themselves as the guardians of morally responsible, hard-working middle-class families.[20]

Such an approach points to another definition of income: what family responsibilities could legitimately be deducted from income before tax was imposed? In 1799, the income tax gave allowances for family responsibilities; the tax code of 1842 did not. The reintroduction of tax deductions

[18] On the case for differentiation, see PP 1852 IX, Second Report from the Select Committee on the Income and Property Tax; PP 1861 VII, Select Committee on Income and Property Tax.
[19] H. C. G. Matthew, 'Disraeli, Gladstone and the politics of mid-Victorian budgets', *Historical Journal* 22 (1979); M. Zimmeck, 'Gladstone holds his own: the origins of income tax relief for life insurance purposes', Bulletin of the Institute of Historical Research 58 (1985).
[20] On Liberal fiscal policies, see P. F.Clarke, *Liberals and Social Democrats* (Cambridge, 1978); on interwar Conservatism, see R. McKibbin, 'Class and conventional wisdom: the Conservative party and the "public" in interwar Britain', in his *Ideologies of Class: Social Relations in Britain, 1880–1950* (Oxford, 1990) and D. Jarvis, 'British conservatism and class politics in the 1920s', English Historical Review 111 (1996).

was again a new Liberal innovation. The reintroduction of allowances for children in the people's budget of 1909 and for wives at the end of the First World War offered a useful device for both Liberal and Conservative politicians to shape the tax code, by increasing the tax rate on large, and above all unearned, incomes and reducing the rate on married men with children in receipt of earned income. The definition of dependants was by no means clear cut: should the concession be limited only to wives and children, or extended to other categories? At what point should children lose the concession? These debates connected with the concern for the future of the British 'race', for tax concessions to children – and above all middle class children – could be one response to the supposed decline in the birth rate of the more intelligent members of society.[21] The issue also had a gender dimension. Even when married women had the right to own their own property, and to be taxed on their own earnings in some circumstances, the Inland Revenue continued to insist that the incomes of husband and wife were aggregated in order to calculate the marginal rate. In their opinion, a married couple formed a single taxable entity, and the income was used jointly. This approach rested on a particular set of cultural and legal assumptions. In the United States, the trend was towards splitting the income between husband and wife for tax purposes, even where the wife did not work for money.[22]

Income might be used not only to support family members, but also to provide charity to the poor or sick. Should charitable donations be set against income, and should the income of charities be tax free? Gladstone was an advocate of philanthropy over state action, and it might be expected that he would seek to encourage charitable giving. In fact, his attitude was more complicated. He was suspicious of endowed charities, for they never died and did not pay death duties; they might be little more than a means of securing posthumous fame, and might be inefficient and wasteful in their management. Endowed charities had an advantage over associational charities which received donations out of taxed income, and were run by living donors who could keep a closer eye on their management. In order to equalise the tax position of the two types of charity, Gladstone tried to

[21] T. Balderston, 'War finance and inflation in Britain and Germany, 1914–18', Economic History Review 2nd ser 42 (1989), 233; for example, see PP 1919 XXIII pt 1, Royal Commission on Income Tax, Third Instalment of Minutes of Evidence, QQ 6885–8 for Sidney Webb. For Churchill's use of the allowances, see M. J.Daunton, 'Churchill at the Treasury: rethinking Conservative taxation policy, 1924–29', Revue Belge de Philologie et de Histoire 75 (1997), 1063–83.

[22] PRO, IR63/5, Income tax on married women's property: claim to exemption or abatement, A. Milner, May 1895; T171/37, Income tax: proposals for separate assessments of the incomes of husband and wife; T171/166, Husband and wife: separate treatment for income tax and super tax purposes. Note by the Board of Inland Revenue, 28 Aril 1919. On the USA, see C.C. Jones, 'Split income and separate spheres: tax law and gender roles in the 1940s', Law and History Review 6 (1988), 259–310.

introduce a tax on corporations such as Cambridge colleges and endowed hospitals. Gladstone faced outrage, and dropped the measure. Of course, the tax position of the two forms of charity could be equalised by another means: allowing donations to associational charities to be exempt from income. The Inland Revenue was highly suspicious, on the grounds that it would lead to anomalies and confusions. The state might allow tax relief to a charity designed to convert Catholics to Protestantism, and to another charity for the conversion of protestants to Catholicism. A man might be giving donations to a charitable hospital to care for the sick wife or child of someone else; would this not lead to a demand for tax relief on anything he spent on the care of his own sick wife and child? The Inland Revenue was fearful of opening up too many exemptions and loopholes, and might even support a collectivist approach. If the state wished to encourage some forms of provision, it would be more efficient to provide the money itself.[23]

These considerations suggest that the question, 'what is income' or more accurately 'what is taxable income', was much debated. The outcomes differed from other countries at the time, and from the current definitions of the British system. We are not dealing with systematic legal thinking so much as a confused mixture of political and cultural assumptions about the virtue of charity, the standing of corporations, the need for savings or the undesirability of socially created income. Judges and lawyers had to grapple with the wording of the acts; businessmen and accountants had their own, different, understandings. Legal reasoning helped to shape the outcome, but must be placed within a much wider context of the political culture of Britain and the electoral calculations of politicians.

[23] D. Owen, *English Philanthropy, 1660–1960* (London, 1964); Parliamentary Debates, 3rd ser 170, 16 April 1863 cols 224d–g and 4 May 1863, cols. 1072–1135; PRO, T171/176, Contributions to hospitals, universities etc: note by the Board of Inland Revenue, 15 May 1920

2

Taxing Foreign Income from Pitt to the Tax Law Rewrite—the Decline of the Remittance Basis

JOHN F AVERY JONES CBE

ABSTRACT

THE PAPER IDENTIFIES and examines three features of the UK system of taxing foreign income. First, we are still using the same wording for taxing foreign income as Pitt's 1799 original income tax, an extreme example of the principle that a statute is 'always speaking' and a tribute to the adaptability of the courts in successfully applying the wording to 200 years of changes, which was not without difficulty in determining whether certain types of income, particularly trading income and employment income, were 'foreign possessions.' Secondly, foreign income is treated as a separate type of income unrelated to the schedular categories of domestic income, which the Tax Law Rewrite proposes to change. Thirdly, the existence of the remittance basis, which originally was not a different basis of taxation but a system for taxing at the time of turning trading profits into money through the mechanism of bills of exchange, which necessarily occurred in the UK because the Navigation Acts required colonial produce, the most important foreign income in Pitt's time, to be shipped in English ships to England,. When methods of trading expanded so that this was no longer the case, the courts tended to cut down the scope of foreign trading income, which in turn led taxpayers to trade through foreign subsidiaries. The decline of the remittance basis during the intervening period is also charted.

I. INTRODUCTION

Only in the United Kingdom could we still impose tax on foreign income by reference to the identical expressions originally contained in Pitt's 1799

Act[1]–'interest arising from foreign securities,' and 'income from foreign possessions.' The courts have successfully adapted these expressions to encompass enormous business changes in the intervening 200 years. That is the most notable feature of our system of taxing foreign income. The second notable feature is that Pitt's two categories of foreign income treat foreign income as a separate type of income unrelated to the categories of domestic income, such as trading profits, interest etc (although one should add that since 1956 foreign employment income has been treated as a type of employment income). The third is the remittance basis, by which, in Pitt's Act most, and in Addington's 1803 Act[2] all, foreign income was taxed to the extent, and at the time, it is brought into the United Kingdom, the scope of which has subsequently been reduced but which still exists today as an important basis of taxation for some individuals.

As to the first feature, the unchanged wording of the charging provisions, it is, fortunately, a principle of statutory interpretation that a statute is 'always speaking,' meaning that the meaning of words should not be ossified the day the statute is passed.[3] That the provisions taxing foreign income have not changed over the past 200 years and still manage to work provides what must be the foremost illustration of this principle. The courts have had no difficulty in accommodating the industrial revolution and all the changes that have taken place since then by enlarging the meaning of 'securities' from mortgages to include company securities (taking in the development of companies on the way); and by enlarging the meaning of 'possessions' from estates in the Colonies (and then recently former Colonies of America[4]) to include all possible forms of income from foreign assets. That is not to say that there were no problems on this journey; there have been doubts whether some types of income could be derived from 'possessions,' and doubts about what made a possession foreign. As the 1955 Royal Commission said: ' … it is not easy to find a category of income that corresponds precisely with the idea of "overseas income."'[5] It was nearly 100 years[6] later that it was determined whether a foreign trade

[1] 39 Geo III c.13, although the Schedule is substituted by c.22, an act that also extended the time limit for making returns. For articles on the 1799 Act see B E V Sabine *Great Budgets* [1970] BTR 201; William Phillips *The Origin of Income Tax* [1967] BTR 103 and *The Real Objection to the Income Tax of 1799* [1967] BTR 177; Chantal Stebbings *The Budget of 1798: Legislative Provision for Secrecy in Income Taxation* [1998] BTR 651.

[2] 43 Geo III c.122. For an article on Addington's Act see William Phillips *A New Light on Addington's Income Tax* [1967] BTR 271. Pitt's Act had been repealed by Addington in 1802 on the short-lived Peace of Amiens by 42 Geo 3, c 42. That Act that was also 'for the effectual Collection of Arrears of the said Duties.'

[3] Cross *Statutory Interpretation*, Butterworths, 1976 p.45.

[4] See the reference to the British plantations in America in Addington's Act in the text at notes 15 and 29. The loss of the American colonies was in 1783.

[5] Cmd.9474 para.631.

[6] One cannot say that the courts had the problem for this length of time because they had no jurisdiction in tax cases until Customs and Inland Revenue Act 1874 s.9 which permitted the

could exist, the courts ultimately deciding that it could but only with an extremely narrow definition. And 150 years later the courts were still trying unsuccessfully to work out whether an employment was a possession, and, if so, what made it a foreign one; the obvious factor, that of working abroad, seemed to be largely irrelevant. The definition of what was foreign employment income had eventually to be settled by statute, but not until 1956.

As to the second feature, that foreign income is a type (or two types) of income in itself, had we started to tax income later we would probably have dealt with foreign income as a category of the same type of UK income. Even in Pitt's time foreign income was important; he estimated the amount of foreign income to be £5m out of a national income of £110m.[7] But no doubt to Pitt foreign income seemed to be unrelated to domestic income. This aspect is to be remedied by the Tax Law Rewrite[8] which proposes to integrate foreign income into the relevant category of income so that, for example, interest, whether domestic or foreign, will be dealt with together. With that will also end the first feature, the use of Pitt's wording to tax foreign income,[9] hence the reference to the Rewrite in the title of this paper, to which we shall return at the end.

We tend to think of the third feature, the remittance basis, as entirely different from taxing income on the arising basis and having to do with movements of money through the international banking system. Its origin was very different and, because of the business changes that have taken place since Pitt's time, the remittance basis may now seem even more different from the arising basis than it did originally. In Pitt's time most foreign trade was with the colonies. The dearth of any markets abroad coupled with rules requiring important colonial produce to be shipped to England in the first place meant that the remittance basis, so far as trading income was concerned (and there was probably little other foreign income), was essentially a basis that charged tax when the produce was sold, necessarily in England. Even in other cases, the system of payment necessarily by bills of exchange, rather than, as now, moving money through the banking system, meant that

General or Special Commissioners to state a case for the opinion of the High Court. One should also bear in mind that income tax was not in force between 1816 and 1842.

[7] Figures quoted by Sabine (see note 1) p.204. On that basis the tax should have yielded £10m but in fact it yielded only £6m. I have not found any Inland Revenue statistics of foreign income before 1875/76 when the total assessments of foreign income were £7m out of a total income assessed of £272m (1875 Report of the Board of Inland Revenue).

[8] The Rewrite project plans to rewrite the whole of the UK primary direct tax legislation to make it clearer and easier to use, without changing the law (apart from minor, identified, changes). For our purposes the relevant document is Exposure Draft No.13 *Foreign Income and Property Income,* March 2002 (ED 13) available on the Internet at http://www.inlandrevenue.gov.uk/rewrite/exposure/thirteenth/ed13.htm

[9] Although the Rewrite's use of 'foreign source,' the use of which is limited to remittance basis income, is identical to 'foreign possessions' (ED13 (see note 8) para.1158) so one could regard it as merely a drafting change.

foreign income would be remitted.[10] It merely meant that the tax was postponed until the income was received in money. It was therefore more of a timing provision than one where remittances were voluntary. When trading evolved and this ceased to be true, the Revenue's attack changed to disputing whether the trade was a foreign one, on which they were broadly successful in the courts. To which taxpayers countered by trading through non-resident subsidiaries, on which in turn taxpayers were broadly successful in the courts, although the courts developed a strict definition of non-residence for companies.

We shall first examine the original charging provisions and the difference between Addington's Cases IV and V, and then look at how the courts defined what income was foreign. Next, we shall examine the origins of the remittance basis and the subsequent reductions in its scope. Finally, we shall refer to the proposals for the removal of the remaining scope of the remittance basis from non-domiciled individuals and look at the Tax Law Rewrite's proposals for reforming the whole system of taxing foreign income.

II. FOREIGN SECURITIES AND FOREIGN POSSESSIONS

The Original Charging Provisions for Foreign Income

In historical articles on taxation one expects to find it said that Addington's 1803 Act[11] was an advance on Pitt's, but in respect of foreign income the credit must go to Pitt. Addington took Pitt's two categories of foreign income with some drafting changes[12] and introduced only one major

[10] See text around note 125.

[11] Addington's tax at 1s in the pound raised £5,341,907; Pitts's at 2s in the pound raised £6,046,996 (Annual Report of the Commissioners of Inland Revenue 1875). The particular differences between the two Acts were first that Addington's required separate returns of income taxable under each Schedule so that no one official knew a person's total income. Sched G sets out 13 separate declarations and two accounts (annual value of property and list of public offices). The separate returns for each Schedule preserved the taxpayers' secrecy, which was then regarded as of prime importance, to a much greater extent than Pitt's, see Chantal Stebbings *The Budget of 1798: Legislative Provision for Secrecy in Income Taxation* [1998] BTR 651. The second main difference was the frequent use of deduction of tax at source, which he copied from earlier taxes. For the origins of deduction of tax at source see Piroska E Soos *The Origins of Taxation at Source in England*, IBFD Publications, Amsterdam, 1998, and the same author's *Taxation at the Source and Withholding in England, 1512 to 1640* [1995] BTR 49.

[12] In relation to other types of income Addington refined Pitt's categories into the familiar Schedules A to E, the income of which could be taxed separately, rather than Pitt's list of 19 Cases, divided into four parts: Lands, tenements and hereditaments, Cases 1 to 14 (the number of cases demonstrating the importance of land even more clearly than Addington's Schedules A and B coming first); personal property, trades, professions, offices, pensions, allowances, stipends, employments and vocations, Cases 15 and 16; income arising out of

difference: he extended the remittance basis to cover interest on foreign securities. The only difference between Addington's Cases IV (interest on foreign securities) and V (income from foreign possessions) was that income was measured by a single year in Case IV and by an average of the three preceding years in Case V,[13] a distinction also found in Pitt's Act. Had Addington designed the system from scratch there might have been only one Case for foreign income, which in practice is where we are today as Cases IV and V are difficult to distinguish for individuals and Case IV no longer applies to companies (although effectively there is another Case for individuals since Schedule E now has its own foreign element; foreign employments were originally a foreign possession). In spite of reducing foreign income to virtually a single category of we have nevertheless managed to create many different sets of rules for different types of foreign income, so the single Case does not represent the reality. We shall start by setting out Pitt's and Addington's charging sections relating to foreign income and, for comparison, the provisions as they are still in force today.

Interest on Foreign Securities

Pitt's 18th case.[14] 'Money arising from Foreign Securities. The Annual Income of such Securities if the same were existing in the preceding Year, to be estimated according to the Produce of such Year, and if the same were not then existing, to be computed upon the expected Produce of the current Year.'

Addington's Case IV.[15] 'The Duty to be charged in respect of Interest arising from Securities in Ireland,[16] or in the British plantations in America, or in any other of His Majesty's Dominions out of Great Britain, and Foreign Securities,[17] [except such Annuities, Dividends, and Shares payable

Great Britain, Cases 17 and 18 (set out under the next heading); and other income not falling under any of the foregoing rules, Case 19. Thus Addington merged Pitt's 14 land Cases into two Schedules, and changed Pitt's remaining 5 Cases into three Schedules with Schedule D subdivided into 6 Cases, a total of 10 categories.

[13] For subsequent changes in the basis, see notes 27 and 45.
[14] Note the numbering; in Pitt's Act foreign possessions came before foreign securities, and the reverse in Addington's Act, perhaps more logically as securities would otherwise be included in possessions, and so 'possessions' coming second can cover the remaining possessions.
[15] 43 Geo III c.122.
[16] Ireland was integrated into the UK tax system by Gladstone's ITA 1853 s.5 (which imposed income tax until 1860 'and no longer' (s.59); it has been renewed annually since 1860, the first extension being by 23 Vict. c.14. By s.7 Irish income was excluded from Cases IV and V and the same rules applied as for the same type of income in Great Britain but these references to Ireland were not repealed until the Statute Law Revision Act (No.2) 1874. The arising basis for Irish income continued on the formation of the Irish Free State under FA 1926 Sched 2 Pt. II see now TA 1988 s.68.
[17] The consolidation in ITA 1918 dropped these descriptions in favour of 'securities in any place out of the United Kingdom.'

[out of the revenue of Ireland] as are directed to be charged under Schedule C[18] of this Act][19]. The Duty to be charged in respect thereof shall be computed on a Sum not less than the Whole and just Sum or Sums (so far as the same can be computed) which have been or will be received in Great Britain, in the current year, without any Deduction or Abatement.'

> *Case IV today.* 'tax in respect of income arising from securities out of the United Kingdom.'[20]

'Securities,' originally, were not securities issued by a company as we think of them today because there were then few foreign companies.[21] The original meaning can be seen from a contemporary explanation of interest arising from securities:

> This is a species of interest payable on mortgage debts, bills of exchange, or other securities, and arising out of foreign profits whether from trade or property. As these remittances are generally received through mercantile houses who act therein as agents, the act is compulsory on them to deliver the following account, according to sect.65 [a list of names and addresses which is now TMA 1970 s.17].[22]

[18] Schedule C charged all profits arising from annuities, dividends, and shares of annuities payable to any person ... out of any public revenue ... . At that time the Government sold annuities.

[19] Added by the 1806 Act (46 Geo III c.65). By then Lord Grenville was Prime Minister and Lord Henry Petty Chancellor of the Exchequer and the rate of tax was increased to 10%, Pitt's original rate. William Phillips describes this Act as what Addington's 1803 Act would have been but for Pitt's opposition ([1967] BTR 271, 280). In particular, deduction of tax at source was extended to Schedule C (s.CV). The words in brackets about Ireland do not appear in the 1842 Act; the 1806 Act s.CVIII recognises the possibility of income from a Colony or Settlement being taxed under Schedule C and so the exclusion of only Irish income taxed under Schedule C may have been too narrow which is why the point was corrected in 1842. The 1806 Act was the model for the 1842 Act by which income tax was reintroduced for three years 'and no longer' (s.193) when Sir Robert Peel was Prime Minister; ss.22 and 23 of that Act gave the right to appeal Schedule D assessments to the Special Commissioners (who had existed since 1805 with administrative functions) as an alternative to the General Commissioners. The expiry of the tax was extended on several occasions until 1853 (from which see note 16).

[20] TA 1988 s.18(3). The reference to 'interest' became 'income', as in Pitt's Act, in the 1914 consolidation, perhaps to include discounts.

[21] See the quotation in the text to note 40.

[22] A Guide to the Property Act 46 Geo III, 2nd ed. Printed and published by Joyce Gold, 1807. I am grateful to Piroska Soos for bring this work to my attention. This contemporary evidence is important since the courts did not have jurisdiction in tax cases until 1874 and so we do not have any contemporary court decisions. For examples where the security was on land, see *Scottish Mortgage Company of New Mexico v McKelvie* (1886) 2 TC 165, *Butler v Mortgage Co of Egypt* 13 TC 803 and *Westminster Bank Executor & Trustee Co (Channel Islands) Ltd v National Bank of Greece* 46 TC 472, where the bonds were also guaranteed. Although not strictly speaking secured the debt for unpaid purchase money for land sold under a contract but not yet conveyed was effectively secured because the contract could be cancelled and the land restored to the seller in *Hudson's Bay Co v Thew* (1919) 7 TC 206 in which the interest was held to be on a security. On the other hand, the banking-type fluctuating advances made

Mortgage debts are secured in the true sense but bills of exchange are secured only if endorsed or 'accepted' when there is security in the sense of something other than the original promise to pay. However, the reference to bills of exchange suggests that the courts have subsequently given too much prominence to security:

> … the normal meaning of the word 'securities' is not open to doubt. The word denotes a debt or claim, the payment of which is in some way secured. The security would generally consist of a right to resort to some fund or property for payment; but I am not prepared to say that other forms of security (such as a personal guarantee) are excluded.[23]

'the word "securities" has no legal signification which necessarily attaches to it on all occasions of the use of the term. It is an ordinary English word used in a variety of collocations: and it is to be interpreted without the embarrassment of a legal definition and simply according to the best conclusion one can make as to the real meaning of the term as it is employed in, say, a testament, an agreement, or a taxing or other statute as the case may be … . Securities in the Fourth Case of Schedule D appear to me to mean securities upon something as contrasted with the possession of something.'[24]

> A security … is a possession such that the grantee or holder of the security holds as against the grantor a right to resort to some property or some fund for the satisfaction of some demand, after whose satisfaction the balance of the property belongs to the grantor.[25]
>
> … investment of money upon securities.[26]

by a wool broker secured partly on real property and partly on stock, wool and other produce in *Smiles v Australasian Mortgage and Agency Co* (1888) 2 TC 367 was 'not investment of money upon securities' (p.377) but trading income. A simple unsecured debt of a foreign company for which promissory notes were later substituted was held not to be a security in *Lord Manton's Trustees v Steele* (1927) 11 TC 549; this is odd since interest on bills of exchange was originally interest on a security. The case left open the status of debt instruments issued by a foreign country, colonial authority or Dominion. There were US government securities at the time. An estimate of £4m British capital invested in US 'funds' in 1801 and £5.7m in 1805 is quoted in R W Hindy *The House of Baring in American Trade and Finance,* Harvard University Press, 1949, p.34. The rather nebulous concept of a security is also still found in 'debt on a security' in capital gains tax, see now TCGA 1992 s.132(3)(b) and *W T Ramsay Ltd v IRC* [1981] STC 174. S.65 mentioned at the end of the quotation in the text did not require a statement of the amount but s.51 of the 1842 Act required this.

[23] *Singer v Williams* (1920) 7 TC 419, 431. This is not to be confused with the trust case of *Williams v Singer* (1920) 7 TC 387 concerning foreign dividends paid through UK trustees to a foreign beneficiary. Both cases deal with dividends from the Singer Manufacturing Company of New Jersey, and the Inspector of Taxes is the same in both. The former case relates to Mr Singer in his personal capacity—'a member of a family which has done much to elucidate the law of Income Tax in England by its struggles to pay no more than the amount that it justly ought to pay in its view' (*per* Scrutton LJ at p.426).
[24] At p.435 and 436 *per* Lord Shaw.
[25] At p.436 *per* Lord Wrenbury.
[26] *Smiles v Australasian Mortgage and Agency Co* (1888) 2 TC 367, 377 *per* The Lord President.

One is left with some uncertainty about precisely what the courts subsequently regarded as securities. A reason for this is that the only distinction between securities and possessions was the difference in basis periods, the current year for securities and the average of the three preceding years for possessions, which ceased to matter when the basis periods became the same for both in 1926.[27]

Foreign Possessions

Pitt's 17th Case. 'From Foreign possessions. The full amount of the actual Annual Net Income *received in Great Britain* either estimating such Receipt in the first Year of being charged at the Election of the Person charged, according to the Year ending the fifth day of February[28] immediately preceding such Estimate, or according to the Average of the three Years preceding such fifth Day of February, or on such Day in each Year on which the Account of such Income has been usually made up; and in all succeeding Years, the Annual Receipt to be reckoned in the same Mode which the Person charged shall have chosen to make in the first Year.'

Addington's Case V. '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"[29] ... computing the same on an Average of the Three preceding Years,[30] as directed in the first Case, without [other][31] Deduction or Abatement.'

[27] For Case IV the current year basis was replaced by the preceding year basis by FA 1926 s.29, following the recommendations of the 1920 Royal Commission (Cmd.615), and reverted to the current year basis by FA 1994 s.207(1) for self assessment reasons; the 1955 Royal Commission had recommended this on practical grounds, such as the difficulty of applying double taxation relief to the preceding year basis (para.785), about which see *Imperial Chemical Industries Ltd v Caro* (1960) 39 TC 374, dealt with by FA 1961 s.18, now TA 1988 s.804. For corporation tax the current accounting period basis was applied by FA 1965 s.51(1), and Case IV ceased to apply for corporation tax by FA 1996 Sch.14 para.5. See note 45 for the changes of basis periods for Case V.
[28] This seems to be to give time for computation as the tax was based on the year to 5 April, s.LXXII. 11 days had been added to the year, which then started on 25 March, for land tax purposes on the (somewhat late) change to the Gregorian calendar in 1752. The position was complicated by leap years and the change to starting the legal year on 1 January, and is fully explained by John Jeffrey-Cook in [1977] BTR 68
[29] The consolidation in ITA 1918 dropped these descriptions in favour of the current 'possessions out of the United Kingdom' see text at note 32. The words omitted here are dealt with in the text at note 121.
[30] See note 45 for the subsequent history of the basis of assessment.
[31] Words dropped in the 1805 Act (probably wrongly). The 1842 Act says: 'without other deduction or abatement than is hereinbefore allowed in such case [Case I]. The Rewrite ED 13 (see note 8) para.1186 suggests that this applies deductions only to foreign trading income,

Case V today. 'tax in respect of income arising from possessions out of the United Kingdom not being income consisting of emoluments of any office or employment.'[32]

As with securities, the wording has effectively remained unchanged since Pitt's time. Today 'possessions' has to cover every type of foreign income other than income from securities.[33] Originally its meaning was much narrower. An idea of what was meant by possessions can be seen from a contemporary explanation of a provision of Addington's Act setting out the various ways of making a taxable remittance to which we shall return:[34]

> The Act considers that the value of foreign property may be brought into Great Britain. 1st, By bills. 2d, From the produce of the *estate* which it calls property, (meaning personal property,) imported into Great Britain, and turned into money here. 3d, From the produce of the *estate* sold in other countries, the value of which is received here. 4th, From money received by the party either on the credit or the account of the produce of the *estate* converted in any of the ways mentioned.[35]

The reference to an 'estate' in the second, third and fourth items demonstrates that the typical foreign possession of the time was immovable property, perhaps a plantation. The reference in Addington's Case V to the 'British plantations in America' is to the same effect.[36] The estate in Antigua belonging to Sir Thomas Bertram of Mansfield Park[37] may have been a typical foreign possession of the time.

the equivalent to Case I income, and not to Case II income. It proposes to change this. The intention of allowing deductions seems to be that if it is the sales from the foreign trade that are remitted, as was originally likely to have been the case, not more than the Case I profit can be taxed. However, there was a problem before the current year basis since capital allowances and losses were not deductible in computing a Case I profit. However, the Revenue did not assess more than what would have been taxable on the arising basis.

[32] TA 1988 s.18(3). The exclusion of employment income dates from 1956, see the heading *What made a possession foreign?* under *Employment and pensions income*. We have not repeated the second sentence of Addington's Case V but it is still to be found in TA 1988 s.65(5)(b).

[33] Even such income as alimony paid by order of a foreign court (*IRC v Anderström* (1927) 13 TC 482) or by deed of separation executed abroad (*Chamney v Lewis* (1932) 17 TC 318).

[34] See text around note 121.

[35] Guide to the Property Act, 1807, see note 22 (our italics). The meaning of 'remittance,' which is a topic in itself, will not be dealt with in this article; this explanation is included here to explain the meaning of 'possessions.' The provision itself and this explanation are discussed in the text around note 121.

[36] See also *The Ormond Investment Co v Betts* (1926) 13 TC 400, 406: '... at the time when the Act of 1842 was passed, as has often been said before, the foreign possessions to be glanced at were foreign undertakings really mainly in the nature of plantations, and so on' *per* Rowlatt J.

[37] Jane Austen, written 1811–13, published 1814.

If foreign possessions originally meant estates abroad, suggesting tangible property, it might imply that intangible property like shares were securities rather than possessions. The distinction between tangible and intangible property may originally have been the practical distinction between the two Cases when securities were the main example of intangibles[38] but this was not the true distinction since it was only *interest*[39] on securities that was within Case IV, so that possessions must include everything else, including income from other intangibles. It is also relevant to whether intangibles are included that when the expression 'possessions' was first used:

> there were few incorporated companies, fewer which were foreign companies, and fewer still which were foreign companies having shares owned in Great Britain, so that, while the Legislature has used language which has been construed as wide enough to include all foreign species of property, what were principally in mind at the time were investments in lands, or in plantations or factories abroad.[40]

The distinction between securities and possessions was still being argued about in 1920,[41] although the courts had before this time consistently held that a share in a company was not a security.

The courts had no difficulty in enlarging the meaning of 'possessions' to cover every kind of foreign asset because if they had not, there were no other charging provisions for foreign income:

> 'Possessions' is a wide expression; it is not a word of technical meaning; the Act supplies no interpretation of it. I cannot see why it may not fitly be

[38] Patents have existed since Elizabeth I; copyright existed at common law and by statute since the Copyright Act 1709.

[39] Dividends are mentioned in relation to the exception from Case IV for Schedule C income (text at note 18), suggesting that interest on securities is limited to interest properly so-called. Note that Pitt's Act did not use the word *interest* but refers to *money, income and produce,* and it is interesting that ITA 1914 reverted to *income,* perhaps to cover discounts. It is unlikely that it was originally intended to have a wider meaning since there were no dividends from companies at the time (see note 40).

[40] *Per* Lord Phillimore in *Singer v Williams* 7 TC 419, 439. Scrutton LJ at p.427 also makes the point that there were no foreign companies before 1842 (the reintroduction of income tax) and so it was unlikely that the word 'securities' was intended to cover shares, a non-existent form of property. Another problem caused by companies being introduced later than income tax is the interpretation of 'public office or employment' in relation to employees, see note 98. Chartered companies existed, such as the Hudson's Bay Company, 'service in which was a kind of aristocracy of employment with old traditions going back to the time of the Stuarts' (*per* Scrutton LJ in *Great Western Railway v Bater* 8 TC 231, 238).

[41] *Singer v Williams* 7 TC 419. This was probably a case of the taxpayer arguing against the effect of the 3-year average on the termination of the remittance basis on dividends in 1914 (see the heading *Cutting down the remittance basis* under *Investment income*), rather than any general doubt about the matter.

> interpreted as relating to all that is possessed in His Majesty's Dominions outside the UK or in foreign countries which is a source of income.[42]

Any apparent difficulty over the limitations of the four statutory ways of making remittances,[43] written with foreign estates in mind, was no obstacle to the courts finding a suitable intention of Parliament:

> ... I cannot think it was ever the intention of the Legislature to say in effect that ... under Case V only those sums received were to be computable which were attributable to the specified operations or sources. I think therefore that these four sub-heads, as they have been called, should be treated as illustrations (no doubt intended to form a comprehensive list of illustrations) of the way in which, when foreign income is transmitted to this country, the transmission can be effected and the sterling sums obtained. These sub-heads, which are not all very clearly phrased, should accordingly be construed according to their general sense without too much nicety of language.[44]

It will also be seen that both Pitt's and Addington's provisions taxed foreign possessions on the remittance basis based on the average of the three preceding years.[45] The difference in the period used for measurement of the income reflects that interest is usually fixed and certain whereas other income is variable and uncertain.[46]

There is an overlap between Cases IV and V and other Cases. A trade within Case I or V may receive interest within Case IV. A trade controlled abroad consisting of making loans secured on land abroad, where the security

[42] *Per* Lord Herschell *Colquhoun v Brooks* 2 TC 490, 502. It was later held that possession as absolute owner was not required; an interest as beneficiary of a trust was sufficient: *Drummond v Collins* (1915) 6 TC 525, a point which led on to the long-running dispute in the *Archer-Shee* cases about the nature of the income of the beneficiary when the remittance basis was removed from certain types of income, see text at notes 143 to 150.

[43] This is dealt with in the text around notes 134 and in the explanation in the text at 35.

[44] *Thomson v Moyse* (1960) 39 TC 291, 337. Lord Denning says at p.342: 'The four heads comprehend almost every conceivable way in which the income can be used to produce sums which are received in the United Kingdom.'

[45] The 3 year average became the preceding year basis by FA 1926 s.29, following the recommendations of the 1920 Royal Commission (Cmd.615), and then the current year basis by FA 1994 s.207(1) for self assessment reasons. The 1951 Millard Tucker Committee (Cmd.8189) had concluded that the current year basis for trading profits was impracticable (para.66), and the 1955 Royal Commission, while agreeing if their terms of reference had been the same as that Committee, had recommended this for trading profits of companies (para.773–4) and for Case IV and V income on practical grounds such as the difficulty of applying double taxation relief to the preceding year basis (para.785). For corporation tax the current accounting period basis was applied by FA 1965 s.51(1), and Case V ceased to apply to income from loan relationships for corporation tax from 1996. In 1926 the House of Lords decided in *Whelan v Henning* 10 TC 263 that if there was no income from a foreign possession in a particular year there could be no assessment based on the 3 year average on the ground that there was no source of income in the year. This was reversed for all Schedules by FA 1926 s 22, now TA 1988 s.71.

[46] See *Singer v Williams* 7 TC 419, 436 *per* Lord Shaw.

was inherent in the trade, has been held to be within Case IV.[47] The Crown has an option to tax under another Case of the same Schedule[48] and may choose Case IV rather than I or V because expenses are not allowed against a Case IV assessment or, as will be seen, after 1914 most investment income was taxed on the arising basis while trading profits were taxed on the remittance basis.

What made a Possession Foreign?

Whether income was from a foreign possession does not pose much difficulty when one is dealing with rent from land abroad or dividends or interest paid by non-resident companies. The answer is much less obvious when dealing with trading and employment income. We shall next examine how the courts dealt with defining whether these were foreign.

Trading Income

One of the difficulties in determining whether a trade is a foreign one is that control may be exercised in one place and operations take place in another.[49] The Act was not exactly helpful in distinguishing UK and foreign trades, because UK trades included any trade whether carried on in the UK or elsewhere[50] and so it was not clear whether a trade could qualify as a foreign possession.[51] Because the courts had jurisdiction in tax cases only

[47] *Butler v Mortgage Co of Egypt* 13 TC 803. On the overlap with Case I, see *Scottish Mortgage Company of New Mexico v McKelvie* (1886) 2 TC 165 in which the Court upheld the Case IV assessment where the interest was secured on land and compare *Smiles v Australian Mortgage and Agency Co* (1888) 2 TC 367 where the business was that of wool brokers who advanced money; the Court decided against Case IV on the basis that the interest was on fluctuating balances secured partly on land and partly on stock, wool and other produce in the manner of a banker's loan and 'not investment of money upon securities' (p.377). It was pointed out that this had the advantage that losses on one transaction could be offset against profits on another, although this is less serious since the remittance basis applied if it were taxed under Case IV. The same problem of assessment under Case III rather than Case I exists where the profits are lower than the interest received, see *Clerical Medical and General Life Assurance Society v Carter* (1889) 2 TC 437. See note 164 for the introduction of relief for management expenses of insurance companies.

[48] *Liverpool and London and Globe Insurance Co v Bennett* (1913) 6 TC 327, now incorporated in the statute in Taxes Management Act 1970 s.28A(7B). The Tax Law Rewrite has proposed to make the guidelines for exercise of the option into statutory rules, see cl.20 and 240 of the draft Income Tax bill in ED 13 (see note 8).

[49] See the 1955 Royal Commission Cmd.9474 para.631.

[50] TA 1988 s.18(1), Sched D (a)(ii), originally in Sched D in s.LXXXIX of the 1803 Act (although then referring to Great Britain).

[51] As Lord Macnaghten points out in *Colquhoun v Brooks* (1889) 2 TC 490, 506, the specific reference to the British plantations in America, see text at note 29, would have been concerns in the nature of trade. The FA 1940 gave statutory recognition to the existence of a foreign trade when it generally removed the remittance basis from income other than trading or employment or pensions income, see the heading *Cutting down the remittance basis, Further reduction in the remittance basis in 1940.*

from 1874 we do not know how these provisions were interpreted but material from 1880 indicates that it was thought that foreign trades did not exist.[52] The point was settled by *Colquhoun v Brooks*[53] (relating to 1884/85) in which the House of Lords decided on the construction of the Act that a trade controlled abroad was a foreign possession. One of the main reasons was that, if this were not the case, the assessing provisions for trades did not deal with trades carried on wholly abroad so that they could not be classed as UK trades.[54] It was explained by Lord Sumner in *Mitchell v Egyptian Hotels Ltd*[55] that the distinguishing feature of a foreign trade was that the trade was controlled from abroad[56] and the UK resident took no part in carrying it on. Confusingly, foreign control of the trade was described as the trade being carried on abroad, so that conversely the trade of the San Paulo (Brazilian) Railway which was controlled from England could be described as carried on in England.

> A director does not get on an engine in America and drive it, but he can say what man shall get on the engine, and how many hours that man shall work and at what pace he shall drive the engine. Everything is done by the order of the directors. They make all the contracts; it is said that they buy all the materials, and it is said that they buy all the engines; and in the trade or business of a railway if you buy bad engines you are pretty certain to come to grief, and where will your whole trade go to? If you buy a series of bad engines your profits will never appear. Then no one in America according to the statement of this case, has any power to do anything but to obey orders. It is beyond discussion and beyond doubt that a great part of this business or trade

[52] See the Opinion of the Law Officers in Scotland (1880) (to be found at the end of 1 TC p.A1 (printed at the end of vol.1) (Indian partnership). This Opinion cites *Sulley v AG* (1860) 2 TC 149 (American partnership) where the main issue was the taxation of the US partners who were held not to be taxable, the only UK activity being purchasing, but the Revenue's question at p.A3 may be misreading the case in stating that the profits of the UK resident partner 'coming home' were the whole profits not the remitted profits as this expression seems more appropriate to the remitted profits (the reason for the existence of a tax case in 1860, when the courts did not have jurisdiction until 1874, is that it concerned an information laid in the Court of Exchequer to enforce a penalty (three times the duty) for failing to deliver the return; this case is also mentioned in argument in *Colquhoun* 2 TC at p.495 and *Tischler v Apthorpe* 2 TC at p.91). The Revenue stated that the issue was one of very great importance particularly in such a mercantile community as exists in Glasgow (p.A.4), suggesting that it was a matter of considerable dispute at the time. I have been informed by Gordon Reid QC that Scottish Inspectors would be bound to follow the Opinion of the Law Officers. It may be that the Revenue were attacking foreign trades on the basis that they lost if the remittance basis applied whereas earlier profits would be remitted anyway, see *III the Remittance Basis, the origins of the remittance basis*.

[53] (1889) 2 TC 490. Lord Macnaghten goes back to Pitt's 1799 Act in reaching his conclusion.

[54] See *Colquhoun* at p.501, 507–8. UK trades were assessed by the Commissioners for the parish or place where the trade is carried on, whether it is carried on wholly or in part in Great Britain (ITA 1842 s.106).

[55] (1915) 6 TC 542, 550.

[56] Statutory recognition of the place of control of the trade in relation to partnerships is found in TA 1988 s.112(1A)(c) in connection with non-domiciled partners.

is done in England by the masters of that trade who are the directors of the English company.[57]

Indeed the Lord Chancellor went further and said that the trade was *wholly* carried on in England.[58] This concentrates on the intellectual control of the trade, to the exclusion of the trading operations themselves. But the expression 'carried on' could also mean where the trading operations took place;[59] the statutory provision 'trade ... whether carried on in the UK or elsewhere'[60] uses the expression in the latter sense. If there is no partnership and a UK resident can direct how his local agents carry on the trade, it is a UK trade even though the control does not 'go beyond passive oversight and tacit control.'[61] Thus the courts had effectively removed the remittance basis from trading income.

It seems strange that the result can be different where there is a partnership since in *Colquhoun* the Australian partner must have been acting as the UK partner's agent in carrying on the trade. The distinction is that a sole trader or company must control the trade because he or it is the only possible 'head and brain of the trading adventure'[62] but with a partnership there are at least two heads and brains and one looks to which one actually controls the trade. Presumably this is a case of 'the acts of every partner who does any act for carrying on in the usual way business of the kind carried on by the firm of which he is a member bind the firm and his partners.'[63] One is concerned with who is actually directing the trade which in

[57] *San Paulo (Brazilian) Railway Ltd v Carter* 3 TC 407 *per* Esher MR at 351.
[58] At 409.
[59] The distinction between the two meanings is made by the Lord Chancellor (Lord Halsbury) at p.410. For the same distinction see *London Bank of Mexico v Apthorpe* (1891) 3 TC 143: 'It is true that part of the profits of that business which is carried on in England is earned by means of transactions carried on abroad. That is not carrying on the business abroad. It is carrying on the business in England by means of some transactions of it which are carried out abroad. But those transactions which are carried out abroad are carried out subject to the directions and at the pleasure and will of the masters and owners of that business resident in London.' 'Carried on' is used in the same sense in relation to the residence of a company: 'That a company resides for the purposes of income tax where its real business is carried on ... ; and the real business is carried on where the central management and control actually abides.' *De Beers Consolidated Mines Ltd v Howe* (1906) 5TC 198, 213 *per* the Lord Chancellor.
[60] See note 50. In relation to non-residents the charge is restricted to any 'trade ... *exercised* within the UK' which also refers to where the trading operations are physically carried out, now TA 1988 s.18(1), Sched.D (a)(iii), originally Sched D of the 1803 Act (although then referring to Great Britain). If therefore a partnership were controlled from the UK the non-resident partners would only be taxed on the profits of the trade exercised within the UK; the resident partners would be taxed on the worldwide profits.
[61] As was the case in *Ogilvie v Kitton* 5 TC 338. The words quoted are from Lord Sumner in *Mitchell v Egyptian Hotels Ltd* 6 TC 542, 551, referring to *Ogilvie v Kitton*.
[62] These words are used by the Lord Chancellor (Lord Halsbury) in *San Paulo (Brazilian) Railway Ltd v Carter* 3 TC 407, 408.
[63] Partnership Act 1890 s.5. The common law position would have been the same and the common law would have applied in Victoria.

the case of the partnership controlled abroad is the non-resident partner and there is no reason to say that he is merely acting as agent for the UK partner.[64] The UK resident partner can even take part in purchasing goods, which is not regarded as trading,[65] without affecting the treatment as a foreign trade.[66] In deciding this, the court was, as we now know unrealistically, trying to find one country in which the trade would be taxed rather than the real issue of whether the trade was UK or foreign: 'If a man were liable to income tax in every country in which his agents are established, it would lead to great injustice.'[67] If the head and mind controlling the trade is outside the UK there seems no reason in principle why there cannot be trading operations carried on (in the sense of physically carried on) in the UK, in which case that part will be taxed under Case I as a domestic trade.[68] It seems that this can no longer apply to UK domiciled partners, and the Rewrite makes clear that a non-domiciled sole trader must physically carry on the trade wholly outside the UK for the remittance basis to apply.[69]

A company is in the same position as an individual,[70] although there was one exceptional circumstance where a company has succeeded in carrying on a foreign trade on its own.[71] It carried on the business of running

[64] From 1940 (see the heading *Cutting down the remittance basis, Further reduction in the remittance basis in 1940*) the remittance basis was restricted to income immediately derived from the trade but this did not affect sleeping partners because there was no requirement for the partner to be 'personally acting therein' as there is in the definition of earned income in TA 1988 s.833(4)(c) and relevant earnings in TA 1988, s.623(2)(c), see note 171.

[65] Perhaps some economic self-interest is behind this: 'It would be most impolitic thus to tax those who come here as customers' *Sulley v A-G* (1860) abstract in 2 TC 149 (misleadingly not in the index to that vol.) *per* Cockburn CJ. Perhaps this is the origin of the provision in Art.7(5) the OECD Model Double Tax Convention that 'No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.'

[66] *Sulley v A-G* (1860) 2 TC 149.

[67] At p.149.

[68] This possibility is recognised in the statute today for non-domiciled partners where the control and management of the trade etc is situated outside the UK, see TA 1988 s.112(1A). This is achieved by first deeming the partner to be non-resident, with the result that the UK profits are taxable under Case I, and also deeming the non-UK profits to be from a foreign possession taxable under Case V on the remittance basis.

[69] Draft clauses in ED13 (see note 8), cl.220. The partnership provisions have not been rewritten yet.

[70] *London Bank of Mexico v Apthorpe* (1891) 3 TC 143 and *San Paulo (Brazilian) Railway Ltd v Carter* 3 TC 344 (CA) and 407 (HL, an unusual example of the proceedings being reported separately in TC) in which the distinction between *Colquhoun* and *London Bank of Mexico* is explored. This is so even though the board of the company delegate their powers to local managers, as in *The Frank Jones Brewing Co Ltd v Apthorpe* (1898) 4 TC 6.

[71] *Mitchell v Egyptian Hotels Ltd* (1915) 6 TC 152 (City General Comrs and High Ct), 542 (CA and HL, another example of the proceedings being reported separately in TC). That was an extremely borderline case with the House of Lords being equally divided, with the result that the Court of Appeal decision stood. The Revenue in International Tax Handbook at para.343 suggest that the company would now be regarded as non-resident (or rather would have been before the incorporation test was introduced in 1988). It was conceded in the case that the

hotels in Egypt, including Shepheard's in Cairo, and appointed a local board in Egypt which under the Articles of the company controlled the trade in Egypt.[72] The UK board had no power over the local board in the running of the hotels and merely declared dividends out of the profits, although they could have starved the local board of funds. The trade was held to be a foreign one. The significant feature was that the UK board had no powers over the Egyptian board; the mere delegation of powers to them would not have achieved the same result.[73] That method of working may have been feasible in 1908/9 for the company running hotels in Egypt but it would not be a solution when communications improved. But what cannot be done with one company can be done with two.[74] The successor to this method of trading was to have a non-resident subsidiary under the control of its local board, with the parent company board exercising only shareholder control over the subsidiary.[75] The cases show an interesting transition, probably encompassing developments both in methods of trading and the understanding of the courts, from the foreign subsidiary being actually managed by the parent[76] to the separate trade of the subsidiary being

company was resident (para.11 of the Case Stated at p.159) and the Commissioners decided that the head and seat and controlling power of the company remained in England with the main board (para.14), so it is not clear that the company would be non-resident if the concession had not been made. In particular, the London board determined the remuneration of the Egyptian board and controlled the finances of the company such as the borrowing power. The Revenue's view is supported by Lord Cave (with whom Lords Dunedin and Sumner concurred) in *The Swedish Central Railway Co. Ltd v Thompson* (1925) 9 TC 342 at 374 who considered that the company would have been resident in Egypt, while Lord Atkinson, dissenting, pointed out that residence was not in issue. It is suggested that the facts do not support Lord Cave since there was a UK board of directors whose powers are summarised by Horridge J at 6 TC 161–2, and the *Swedish Central Railway* is a case which should have decided that the company was non-resident. The 1920 Royal Commission (Cmd.615) para.40 recommended treating foreign boards of UK companies as being controlled in the UK. There is a somewhat similar Irish case where trustees delegated their powers to carry on business in Australia under an irrevocable power of attorney and were held to have Case V income: *Ferguson v Donovan* 1929 IR 489. A possible distinction from *Ogilvie v Kitton* 5 TC 338 is that the trustees would not have had the knowledge to direct the trade in Australia so they were not even exercising passive oversight.

[72] See the articles of association quoted at 6 TC at p.154–5 which makes it clear that the Egyptian business was under the control of the Egyptian board to the exclusion of any other board. It would therefore have taken a third party, the shareholders, to change this.

[73] As was the case in *B W Noble Ltd v Mitchell* (1927) 11 TC 372 where the UK board delegated their powers to run the Paris branch to a French resident director. The UK board were still responsible for the running of the whole business of the company, and the French business was part of the whole.

[74] This is not to suggest that the only reasons for having foreign subsidiaries are tax ones.

[75] The 1920 Royal Commission (Cmd.615) para.40 recommended that the subsidiary should be deemed to be controlled in the UK in order to avoid differences between active and passive control. This was never adopted but CFC legislation effectively does the same in a more targeted way.

[76] *Apthorpe v Peter Schoenhofen Brewing Co Ltd* (1899) 4 TC 41 where a US subsidiary which had formerly carried on the trade continued merely to hold real property as required by local law; *St Louis Breweries v Apthorpe* (1898) 4 TC 111 where the UK company controlled the foreign subsidiary's trade. The difference between shareholder control and control of the subsidiary's trade does not seem to have been clearly understood by the UK parent company;

accepted first for a 98 per cent subsidiary (*Kodak*[77]), and ultimately for a wholly-owned subsidiary (*Deutsche Grammophon*[78]). Thus the courts, having removed the remittance basis for trading income in a single company, had effectively restored it so long as there was a non-resident subsidiary, but at the same time the courts developed a strict definition of non-residence. The dividends remitted to the parent company were taxed as income from a foreign possession. Even after the ending of the remittance basis for dividends from non-resident subsidiaries, the result was similar since the amount of dividends could be determined by the taxpayer, thus eventually leading to controlled foreign companies legislation.

The position was therefore reached that there was very little scope for a trade to be a foreign possession unless there was a partnership controlled abroad. Profits from carrying on, as opposed to controlling, a trade abroad were taxable in full and so the remittance basis had little application. This in turn led to a demand for double taxation relief for the foreign tax suffered on the same profits. Colonial income tax relief was introduced in 1916 although mainly as a result of the removal of the remittance basis for foreign investment income in 1914;[79] this became Dominion Income Tax Relief by the Finance Act 1920.[80]

When the remittance basis did not apply, there was the additional problem of measuring the foreign trading income. *Colquhoun* demonstrates the difficulty of doing this nearly a century later. The Revenue were arguing for the arising basis to apply to a share of income from an Australian partnership carrying on the business of window glass, oil, and colour merchants, and storekeepers in Melbourne, the City General Commissioners, who correctly found against the Revenue, and one would expect to be financially

the articles included power 'to manage the affairs or take over and carry on the business of any such American Company.' The US subsidiary in *Bradbury v the English Sewing Cotton Co Ltd* (1923) 8 TC 481 had formerly been controlled in the UK (and had been found to be resident in *the American Thread Co v Joyce* (1913) 6 TC 1 and 163); it changed its residence in 1917. The separate trade of the foreign subsidiary was recognised in *Bartholomay Brewing Co v Wyatt* (1893) 3 TC 213 and *Nobel Dynamite Trust Co v Wyatt* (1893) 3 TC 224.

[77] The distinction between shareholder control and control of the trade is clearly made in *Kodak Ltd v Clark* (1903) 4 TC 549 concerning a UK company which owned 98% of the shares in the American Kodak Company. UK holding companies seem to have been surprisingly common at the time (see also next note).
[78] The distinction between shareholder control and control of the trade was accepted where the foreign company (*Deutsche Grammophon AG*) was a 100% subsidiary of the UK company in *Stanley v The Gramophone and Typewriter Co* (1908) 5 TC 358.
[79] See the heading *Cutting down the remittance basis, investment income* below.
[80] FA 1916 s.43; FA 1920 s.27. Colonial income tax relief limited the rate in the UK to 3s 6d (17.5%), while dominion income tax relief (which also applied to territories under protection or mandate) was limited to half the UK rate. For the subsequent history of double taxation relief see *Double Taxation Relief for Companies,* a discussion paper, Inland Revenue, March 1999, and R. Willis *Great Britain's Part in the Development of Double Taxation Relief* [1965] BTR 270. The subject will not be included here.

sophisticated, record that the profit measured on the arising basis was computed 'by an estimate and valuation on taking of stock on a certain fixed date after deducting therefrom the estimate and valuation of the preceding year, but as a matter of fact only a portion of the amount had been actually realised.'[81] This does not bear much resemblance to the method of measuring profit for tax purposes either then or now. The remittance basis avoided all such accounting problems; it was easy to measure remittances of cash.

Trading Income: Comparison with the Rest of Europe

The only way to avoid tax being charged on an arising basis on foreign trading activities was to carry on the trade abroad through subsidiaries managed abroad. It is interesting to compare the result with the European exemption system for foreign trading profits. The mainland European approach is not to try to measure foreign trading profits and just exempt them, at least where the profits are attributable to a permanent establishment.[82] European countries did not, as we did, start an income tax from nothing, they had *impôts reels*, an untranslatable expression for a series of separate taxes imposed on different types of income on a source basis, such as a tax on land, and a tax on business profits etc.[83] The first income tax, the *dixième*, imposed in France by Louis XIV in 1710 was a tax on real property, salaries, securities and businesses.[84] No question of taxing foreign income arose. As late as 1923 *impôts reels* were the only form of taxation in Europe at the time of the League of Nations Report by Professors Bruins, Einaudi, Seligman and Sir Josiah Stamp, which report was the beginning of the search for a solution to the problems of double taxation. The Report has a section beginning: 'In this section we shall discuss the income tax proper in its developed form, as found in Great Britain, the United States and the German Empire.'[85] When European countries adopted an income tax, this also had

[81] Para 6 of the Case Stated at p.491. This might be seen as a forerunner of the balance sheet approach in Accounting Standards Board's Statement of Principles for Financial Reporting issued in 1999.
[82] The expression used in the OECD Model Tax Convention and normally also in internal law in mainland European countries for something in the nature of a branch.
[83] This approach is found in the present tax in Hong Kong described in Michael Littlewood's paper *Tax Reform in Hong Kong in the 1970s* in chapter 16 of this book. It is interesting to speculate whether the European taxes influenced the UK colonial model income tax ordinance (1922) which existed in many territories until the 1930s and of which Hong Kong's tax is a surviving example.
[84] William Phillips *The Origin of Income tax* [1967] BTR 113, 117 quoting Seligman *the Income Tax* (1911). I am assuming, without having verified it, that foreign income was not taxed by the *dixième*.
[85] Report on Double Taxation, League of Nations 1923 p.45. There is also a reference to an 'Italian tax contemplated by the law of 1919, the enforcement of which has recently been postponed;' it was introduced in 1925.

some source taxation; this applied to income from immovable property, mortgages, an unincorporated industry or business, and earned income.[86] The existing tax and the new income tax fitted together by means of the income tax exempting anything covered by other country's source-based tax, leaving the income tax to apply to a residual category. Accordingly the European countries continued in their income taxes to exempt foreign earned, and property, income for both corporations and individuals, so the problems of measuring such income were avoided, and they had no need for the remittance basis. The measurement of foreign investment income (as opposed to making sure that taxpayers declared it[87]) was not a problem for European countries by the time they started to tax it by their income taxes in the 1920s. By then the UK had substantially removed the remittance basis for investment income.

The UK and the European approaches thus define foreign trading income differently: the UK concentrating on the person controlling the trade, which meant that a trade controlled from the UK would be taxed as a UK trade wherever it was physically carried on, and the European concentrating only on the geographical source of income probably because that was the basis for their *impôts reels*, and exempting income from a trade physically carried on abroad.[88] Geographical source is not important for residents in the UK system because they are taxed on worldwide income; source (in the UK sense) merely determines how one taxes it, traditionally on the remittance basis if it is foreign source. For a non-resident, in both systems, geographical source determines what income is taxed so that a branch in the country concerned is always taxed to whomsoever it belongs.[89] In the UK this result is achieved by using a different expression, that a non-resident is taxed on a trade *exercised within* the UK.[90] A non-resident is not taxed under Cases IV and V, presumably on the basis that they are unlikely to be controlling a foreign trade from the UK, although since 1965 a non-resident company is liable to corporation tax under those cases[91] in order to tax foreign income

[86] Double Taxation and Tax Evasion, Report and Resolutions submitted by the Technical Experts to the Financial Committee of the League of Nations, 1925 p.13.
[87] A debate that is still continuing in relation to the proposed EU Savings Directive.
[88] The distinction between the two approaches can be seen clearly in the territorial tax system of Hong Kong where in order to be taxable there must both be a trade carried on in Hong Kong (the same as the UK test) and also the profits must be 'profits arising in or derived from Hong Kong.' Thus profits made by a Hong Kong bank from trading in certificates of deposit on markets in London or Singapore did not arise in and were not derived from Hong Kong: *Comr. of IR v Hang Seng Bank Ltd* [1990] STC 733, particularly 736e. A similar Indian case was relied upon which decided that profits of an Indian commodity broker made on exchanges outside India were not profits 'accruing or arising in British India', (p.739e)
[89] The UK taxes a branch in the UK as a UK trade because it is physically carried on in the UK. Control is not relevant since this is used to decide the type of income, UK or foreign, not whether to tax it.
[90] Now TA 1988 s18(1) Sched D (a)(iii).
[91] Case IV does not apply to companies after 31 March 1996, see TA 1988 s.18(3A).

attributable to a UK branch.[92] The difference between the two approaches can be seen at its most extreme in relation to the profits of a foreign branch. These profits are part of the UK trading profit and taxed in full if the trade is controlled from the UK because we look at it from the standpoint of the UK resident trader; in Europe they are not part of a domestic source but are a source of income in the other country and accordingly the residence state exempts them from tax. Thus while the UK system favoured trading abroad through a non-resident subsidiary, the European exemption system allowed trading through a branch of the same company. The results are similar; exemption of the foreign profits from residence state taxation until distribution to the shareholders as dividends in the exemption system or until distribution to the parent company in the UK system with a foreign subsidiary. The UK admits of the possibility of a third category, the overseas controlled trade carried on outside the UK which is effectively limited to partnership cases. Here the remittance basis applied; in the European approach, it is just another case of a foreign branch and exempt. The results are again similar; exemption until distribution to shareholders in the exemption system, and until remittance to the head office in the UK system.

This main discrepancy between the UK approach of taxing foreign branch profits in full and the European system of exempting them where the trading was carried out in one company led the 1955 Royal Commission to look at exemption but they found it impossible to agree to adopt exemption. There were three camps, which we would now recognise as those favouring capital import neutrality, those favouring capital export neutrality, and the pragmatists. In the end the pragmatists won and the Commission recommend a special case where exemption might be used, the overseas trade corporation on the lines of the US Western Hemisphere trade Corporation or the Canadian foreign business corporation.[93] This recommendation was taken up in 1957[94] and provided a method of exempting trading profits from a trade carried on wholly abroad until the income was distributed. In that respect it is very similar to the remittance basis. The difference is merely that the remittance basis taxes income reaching the UK, while trading profits of an overseas trade corporation were taxed on distribution. The exemption for overseas trade corporations was abolished in 1965. The debate about exemption was revisited in a discussion paper on Double Taxation Relief for Companies[95] but no changes were made to the

[92] FA 1965 s.54(8), now TA 1988 s.70(3), now referring to Cases III and IV since Case IV no longer applies to companies, see previous note. Non-resident companies are liable to corporation tax on trading income arising directly or indirectly through or from the branch or agency in the UK and any income from property or rights used by, or held by or for, the branch or agency, s.11(2). There is no comparable provision for individuals.

[93] See Appendix III of the 1955 Royal Commission Report Cmd.9474.

[94] FA 1957 s.23 onwards.

[95] Inland Revenue, March 1999.

present system. Exemption was, however, introduced for capital gains on the disposal of subsidiaries, including foreign subsidiaries, in 2002.

As we have seen, mainland European countries had no need for the remittance basis as they exempted foreign income. Accordingly it seems that Britain's use of the remittance basis was unique although no doubt it is still to be found in countries which based their tax system on ours. The only current example of the use of the remittance basis is in Japan which uses it for taxing a non-permanent resident, meaning an individual who has no intention of residing permanently in Japan and who has been resident there for 5 years or less.[96] The basis of taxation on foreign source income is the income paid within Japan or remitted to Japan from abroad.[97]

Employment and Pensions Income

The other difficult category for determining what constituted a foreign possession was employment income. The position here was complicated by the fact that some employments were taxed under Schedule E and some under Schedule D. Schedule E had its own territorial provision in taxing on a current year basis the emoluments of 'every public office or employment of profit within the United Kingdom';[98] other employments, both UK and foreign, were taxed under Cases II or V Schedule D on the average of the three preceding years, the latter effectively being the residual category. For Schedule E not only was there a problem of determining what offices or employments were 'public', but it was also necessary to determine whether it was 'within the United Kingdom': 'The office of a director is something notional; its locality is one degree, if that is possible, even more notional.'[99] Public offices with a UK resident body were treated as located in the UK.[100] Thus a non-resident director of a UK company, surprisingly even a private company was public for this purpose, performing all his duties outside the

[96] Income Tax Law art.2(1)(iv). The existence of the remittance basis in Japan is mentioned in *Residence in the UK*, Inland Revenue Consultative Document, 1988, Annex D.

[97] Income Tax Law art.7(1)(ii).

[98] 1803 Act Sched E Third Rule. The term was originally derived from Land Tax, see note 114. The antiquity of the phrase made it difficult to apply to employees of the new class of companies which were then being formed, such as the fourth grade clerk in *Great Western Railway Co v Bater* (1922) 8 TC 231 in which the House of Lords departed from the practice that had grown up of virtually ignoring the word 'public' (see Rowlatt J at p.235) and held that he did not hold a public office. The result was that tax could not be collected from the employer, leading to a change in the law by FA 1922 s.18 moving all UK employments to Schedule E but leaving foreign employments taxed under Case V.

[99] *McMillan v Guest* (1942) 24 TC 190, 203 per Lord Wright.

[100] *McMillan v Guest* (1942) 24 TC 190. One might be forgiven for thinking that Rowlatt J's dictum in *Proctor v Ryall* (1928) 14 TC 204, 214 that 'the place of exercise governs' was more sensible. Although he was reversed by the courts, his test is the one Parliament later adopted for defining a foreign employment. This view seems to have been different from his decision on Schedule D in *Pickles v Foulsham* (1923) 9 TC 261, see next note.

UK was deemed to hold a public office within the UK because the company was managed from the UK and he was entitled to attend board meetings in the UK. He was therefore taxable on the whole remuneration, an unusual example of a non-resident being taxed on work done outside the UK, which was another factor indicating that trade should be through non-resident subsidiaries.

The Schedule D position regarding foreign employments was no easier. There was still doubt as late as 1925 about whether an employment could be a possession at all, and if it could what made it a foreign one (the obverse of the Schedule E question of what made a public office one within the UK)?

> It was argued by the Solicitor-General that this gentleman's (I can hardly state it) agreement, or his occupation, was a foreign possession .... He really has not anything, if you use it as a word of possession. There is nothing he can sell; there is nothing he can leave; there is nothing which exists. He is *de facto* employed under a contract; he has a contractual right to keep on being employed, and I, for my part, cannot see how it is possible to say that he has got a possession; but if he has got a possession it is not a foreign one, because the only thing that is foreign is the place where his duties have to be performed. His rights are not foreign; they are as much British as anything else, if they have any locus, because it is a contract with a British company.[101]

Rowlatt J was on this occasion overruled by the House of Lords which looked for a possession and in doing so perhaps over-concentrated on the employment contract, just as the courts did in relation to sales contracts in deciding whether a non-resident was trading in the UK.[102] Having found a possession the more difficult question was what made a contract foreign:

> The House of Lords ... in *Foulsham v Pickles* have definitely decided that, in the case of an employment, the locality of the source of income is not the place where the activities of the employee are exercised but the place either where the contract for payment is deemed to have a locality or where the payments for the employment are made, which may mean the same thing.[103]

It may be said that the question of how one determined the locality of the contract was never settled by the courts and it was determined by

[101] *Pickles v Foulsham* (1923) 9 TC 261, 276 *per* Rowlatt J. The House of Lords decision was in 1925. The same issue later arose over whether rights under an employment contract were assets for capital gains tax: *O'Brien v Benson's Hosiery (Holdings) Ltd* [1979] STC 735.
[102] See, *e.g. Balfour v Mace* (1928) 13 T C 539, 558.
[103] *Bennett v Marshall* 22 TC 73 *per* Romer LJ at 94 quoted with approval by Lord Normand in *Bray v Colenbrander* (1953) 34 TC 138, 157 as stating the ratio of *Foulsham v Pickles* 9 TC 261.

legislation in 1956, some 150 years after Addington's Act. The Royal Commission of 1955[104] reported just before the question was determined by legislation in accordance with their recommendation. They said this:

> 297. '… it has been made plain to us that it is extremely difficult to say whether an employment which contains elements of a foreign character is or is not to be treated as a foreign possession for this purpose.
> 298. There is no statutory rule. In the absence of one the Courts have had to treat each question as one of fact and to decide it according to the balance of what seem to be the relevant considerations. There is the nationality, domicile or residence of the employer. As the employer is normally a corporation, that test is likely to be somewhat artificial anyway. Then there is the country in which the contract of employment is made, which may or may not correspond with the national system of law by which it is to be governed. Thirdly, there is the country in which the moneys earned by the employment are paid, though it by no means follows that the whole salary will be paid in any one country. Lastly, there is the country in which the work is to be done: again two or more countries may be involved.[105]
> 299. We regard this state of affairs as unsatisfactory … .
> 300. We recommend therefore that a statutory rule should be enacted to the effect that (a) the income arising from an employment performed wholly abroad is income from a foreign possession, and (b) the income arising from an employment performed wholly in the United Kingdom cannot be a foreign possession.'

This recommendation was immediately adopted in a slightly different form which moved all employment income to Schedule E so that one did not have to identify any employment income as a foreign possession but it could contain its own definition suited to employment income.

In 1922[106] following the recommendation of the 1920 Royal Commission, all employments, except those which were taxed as foreign possessions, were moved to Schedule E and so this change did not affect foreign employments so long as they were not from public offices or employments within the United Kingdom. The 1955 Royal Commission recommended that this distinction between public and other employments be abolished as no one knew what it covered.[107] This recommendation was accepted and as a result the

[104] Cmd.9474.
[105] The Income Tax Codification Committee 1936, Cmd.5131, set out the Revenue's practice at the time, which was to treat duties performed abroad for a non-resident employer, and also those for a UK resident employer which were paid abroad, as being within Case V. The 1920 Royal Commission (Cmd.615) para.26 had recommended that the former should be on the remittance basis.
[106] FA 1922 s.18.
[107] Para.305.

remaining employments were moved to Schedule E in 1956 and the treatment of the foreign element was set out in the statute for the first time.

The rationalisation of foreign employments in 1956 resulting from the Royal Commission's recommendations was that the remittance basis applied to an employment all the duties of which were performed outside the UK. Secondly, and contrary to the Royal Commission's recommendation in paragraph 300 quoted above, an exception was introduced to continue the remittance basis for those domiciled abroad on 'foreign emoluments,' wherever the duties were performed, thus including duties in the UK. Foreign emoluments are emoluments of a non-domiciled employee from a non-resident employer.[108] This effectively continued the existing case law.[109] Thus non-domiciled persons retained their own provisions for the remittance basis, as they had done in the 1914 changes to taxation of investment income dealt with below. There was also a relief for non-ordinarily resident individuals which, in accordance with the Royal Commission's recommendation in relation to investment income,[110] was not limited to Commonwealth and Irish Citizens; they (and also non-residents) were taxed only on work done in the UK. For the first time one could identify what was a foreign employment.

There was no similar problem with identifying whether a pension was a foreign possession. The possession is the pension fund.[111]

III. THE REMITTANCE BASIS

The Origins of the Remittance Basis

How did the remittance basis arise? The precedents available to Pitt for taxing foreign income were not helpful. The Land Tax did not attempt to tax land abroad which at that time would have been a breach of sovereignty[112] but it did, despite its name, at least in theory,[113] tax personal property abroad:

> … all and every such Person and Persons … having any Estate in ready Money, or in any Debts whatsoever owing to them, within Great Britain, *or without,*

[108] Technically 'any person, body of persons or partnership resident outside, and not resident in, the UK,' thus envisaging the possibility of dual residence: Schedule E as substituted by FA 1956, s.10. Irish resident employers are excluded: now TA 1988 s.192(1).

[109] *Bray v Colenbrander* (1953) 34 TC 138 concerning two foreign nationals, who would no doubt have been non-domiciled if that had been relevant, working wholly in the UK for foreign employers under contracts made abroad and who were paid abroad. They were held to have foreign possessions.

[110] See text at note 160.

[111] *Aspin v Estill* [1987] STC 723, *Albon v IRC* [1998] STC 1181.

[112] Estate duty was imposed on land abroad for the first time by FA 1962 s.28. The sovereignty argument was also unsuccessfully raised in Parliament when the remittance basis was removed from foreign rent in 1914.

[113] Martin Daunton, *Trusting Leviathan, the Politics of Taxation in Britain 1799 to 1914*, Cambridge UP, 2001, p.33 says 'In theory, this tax [Land Tax] was a national rate of 1s, 2s, 3s, or 4s in the £ on the income not only of land but also of personal property and office … . Reality was different, for the tax was confined to land … '.

> or having any Estate in Goods, Wares, Merchandises, or other Chattels or Personal Estate whatsoever within Great Britain, *or without,* belonging to, or in trust for them ... shall yield and pay unto His Majesty the Sum of Four Shillings in the Pound according to the true Yearly Value thereof for One Year; (that is to say), For every One hundred Pounds of such ready Money and Debts, and for every One hundred Pounds of such Goods, Wares, Merchandises, or other Chattels or Personal Estate, the sum of Twenty Shillings, and so after that Rate for every greater or less Sum or Quantity, to be assessed, levied, and collected in Manner herein-after mentioned;[114]

There is no attempt to do anything other than tax the full amount of the assumed yield of 1 per cent.[115] Indeed it would not be possible to apply the remittance basis to an assumed yield.

The immediate forerunner of Pitt's income tax, the Triple Assessment[116] of the year before, during the debates on which Pitt promised not to

[114] Land Tax Act 1797 38 Geo III c.5 s.III (my italics). The Land Tax Perpetuation Act 1798 (38 Geo III c.60), which made land tax into a perpetual tax with a fixed quota for each town, parish etc, and moved the taxation of personal property into another Act which was not perpetual, and like income tax today, had to be renewed every year. The first of such Acts was 39 Geo III c.3, which covered the same assets and applied for the year beginning 25 March 1799 and therefore applied at the same time as Pitt's income tax of 1799. Notwithstanding the Perpetuation Act the land tax on the list of shares in s.57 of the 1797 Act was made redeemable by the Land Tax Redemption Act 1802 (42 Geo III c.116). See Piroska E Soos *The Origins of Taxation at Source in England*, IBFD Publications, Amsterdam, 1998, p.140. The 1797 Act went on to tax: 'all and every Person and Persons ... having, using, or exercising, any publick Office or Employment of Profit in England, Wales, or Berwick, as aforesaid ... and ... all and every Person and Persons ... having an Annuity, Pension, Stipend, or other Yearly Payment, either out of the Receipt of His Majesty's Exchequer in England, or out of any Branch of His Majesty's Revenue in England, Wales, or Berwick, or payable or secured to be paid, by any Person or Persons whatsoever, in England, Wales, or Berwick ...'—which did not extend to foreign employments or annual payments. Note the Land Tax origin of 'public office or employment' which was to be taken over into income tax. Section 57 also taxed shares in the New River Company (which was logical as they were regarded as realty), in the Thames waterworks, Marybone or Hampstead waterworks, in any office or stock for insuring of houses in case of fire, or in any lights, or in the stock of the king's printing house, and all companies of merchants in London and the Bank of England, all of which are clearly in the UK. Also of historical interest is the definition of land in s.IV, dating from 1688 (see William Phillips *No Flowers, by Request* [1963] BTR 285, 291) to include 'quarries, mines ... iron works, salt-springs, and salt-works, all allom-mines and works, fishings, tolls ...' all of which are still to be found in TA 1988 s.55, having been moved to Sched D by FA 1926 s.28, having been subject to Sched D rules although taxed under Sched A by Customs and Inland Revenue Act 1866 s.8. The Tax Law Rewrite has preserved this in the draft Income Tax Bill in ED 13 cl.9. On the history of land tax, see William Phillips *No Flowers, by Request* [1963] BTR 285.

[115] It is interesting that in 2001 the Dutch changed their income tax to tax an assumed yield of 4% from savings and investments in order to prevent interest deductions being claimed against the income. For an article in English describing the change, see Gerard T K Meussen *Income Tax Act 2001* 40 European Taxation (2000) p.490. The US regards this as a substantially similar tax to the Netherlands income tax named in the treaty for the purpose of giving credit: Rev Rul 2002–16.

[116] 38 Geo III c.16. Simon's Taxes records that 'it was associated with a scheme proposed by the Speaker, Addington, from an idea by John Bowles in 1796 (Two letters addressed to a British Merchant, 4th edn pp 31 and 76) that voluntary contributions in excess of the Triple Assessment might be made to the Bank of England; this scheme raised almost as much as the main tax itself had produced.'

impose an income tax, allowed persons to elect to pay 10 per cent tax, with some lower rates for smaller incomes and nothing on an income of £60, on their total income as an alternative to paying a multiple (not always three times despite its popular name) of the amount of the previous year's tax on various luxuries, but it contained no provisions for computing such income. That the Triple Assessment yielded only half its expected yield[117] with large numbers of people declaring incomes of under £60, was the cause of Pitt having to go back on his promise and impose an income tax in 1799, which turned out to be not much more successful, collecting only £6m out of the estimated £10m. It seems likely therefore that there was no attempt to tax the actual income of foreign property before Pitt's 1799 Act.

Starting therefore with a blank sheet one might well come to the same answer as Pitt's advisers about the remittance basis. For Pitt, but not Addington, interest on foreign securities was sufficiently certain to be taxed in full, not on the remittance basis. The administrative problems of taxing any other type of foreign income, particularly foreign trading income required a practical solution effectively taxing goods received in the UK when they were turned into money, in other words, the remittance basis. The arguments in favour of such a system were not only practical ones. Lord Herschell in *Colquhoun*[118] made the argument of principle that the trade carried on in Australia did not enjoy the protection of the laws of this country.[119]

Although this article does not deal with the meaning of remittance, further understanding of the nature of the remittance basis can be obtained from the provisions of Addington's Case V setting out the methods by which taxable remittances were made:[120]

> The Duty to be charged in respect thereof shall be computed at not less than the full Amount of the actual Sums annually *received in Great Britain*, either [1] for Remittances[121] from thence payable in Great Britain, or [2] from Property imported from thence into Great Britain, or [3] from Money or Value received in Great Britain, and arising from Property [of any Person or Persons],[122] which

[117] The yield was £1,855,996 (1875 Report of the Board of Inland Revenue).
[118] (1889) 2 TC at p.492.
[119] The protection of English law was also relevant to making a company managed here taxable as a resident: 'Otherwise it might have its chief seat of management and its centre of trading in England, under the protection of English law, and yet escape the appropriate taxation ... ' *de Beers Consolidated Mines Ltd v Howe* (1906) 5 TC 198, 213 *per* the Lord Chancellor.
[120] This comes immediately after the passage quoted in the text at note 29.
[121] Addington's Act used the word 'remittance' for the first time. ITA 1918 changed *for* remittances to *from* remittances, which makes more sense. The numbers in square brackets added to the second sentence is to help tie the items into the explanation immediately following.
[122] Words dropped by Pitt's 1805 Act (45 Geo III c.49), Pitt having returned to office in 1804, which re-enacted Addington's 1803 Schedules and Rules with some amendments.

> shall not have been imported in Great Britain, [or [4] from Money or Value so received on Credit or on Account in respect of such Remittances, Property, Money, or Value, brought or to be brought into Great Britain][123] ....

This is explained by the contemporary work from which we have already quoted and repeat again:

> The Act considers that the value of foreign property may be brought into Great Britain. 1st, By bills. 2d, From the produce of the estate which it calls property, (meaning personal property,) imported into Great Britain, and turned into money here. 3d, From the produce of the estate sold in other countries, the value of which is received here. 4th, From money received by the party either on the credit or the account of the produce of the estate converted in any of the ways mentioned.[124]

The first item ('remittances from thence [abroad] payable in Great Britain') is explained laconically as 'by bills.' Suppose the British resident owner of the plantation wants profits in Great Britain. Moving money (necessarily bullion) internationally at the time was dangerous (storm, pirates, French warships) and expensive and was not in practice carried out. Instead bills of exchange were used. Here is an account from a book on the history of bills of exchange:

> Consider a hypothetical English merchant who has sold goods through his factor[125] in Flanders. Suppose that there is someone else in Flanders who wishes to buy goods for export to England, but lacks sufficient funds. ... .The English merchant's factor in Flanders would deliver the money to the Flemish merchant, who would draw a bill of exchange on his factor in London, instructing him to repay the value to the English merchant. Needless to say, one would expect that the amount to be repaid in London would exceed the amount advanced in Flanders, the difference being the interest paid by the Flemish merchant on the loan.[126]

[123] Words added by the 1805 Act.
[124] Guide to the Property Act, 1807, see note 22.
[125] This was the customary way of doing business. The buyer was not concerned that this is an international transaction and merely paid the agent (factor or commission agent) either in cash or on credit probably by means of the issue of a bill of exchange. J S Rogers *The Early History of the Law of Bills and Notes*, Cambridge University Press, 1995, p.33–5. Quoting from another author he says 'By the end of the sixteenth century, the commission system ... was tending to become general. All merchants—in Italy or in Amsterdam for instance—worked on commission for other merchants, who did the same for them.' Later London and Liverpool took over from Amsterdam. The commission agent was recognised in tax legislation that a non-resident was not taxable on transactions carried out through a broker (defined to include a general commission agent) in the ordinary course of his business as such in what was TMA 1970 s.82 deriving from FA 1925 s.17 (since repealed by FA 1995). For the history of this and its influence on art.5(6) of the OECD Model Tax Convention, see J F Avery Jones and D A Ward *Agents as Permanent Establishments under the OECD Model Tax Convention* [1993] BTR 341, 355.
[126] J S Rogers (see note 125) p.37. The interest on the bill would incidentally be taxed under Case IV.

If one substitutes an English owner of a foreign[127] estate for the English merchant, the transaction would have been exactly the same. This example incidentally shows the dual nature of bills of exchange as a substitute for moving money and as a method of financing. Alternatively, bills of exchange could be used to match trade in opposite directions, again without moving money between countries:

> Suppose, for example, that an Italian merchant shipped spices from Italy to his representative in Flanders. Once the agent in Flanders had sold the spices, he would have funds in Flanders due to his principal in Italy. Suppose that another merchant in Flanders was in the business of buying English wool and shipping it to Italy. Once the Flemish wool merchant's agent in Italy had sold the goods, he would have funds in Italy due to his principal in Flanders. The problem of making returns could be solved by having the Italian spice merchant's factor in Flanders pay money to the wool merchant, and the Flemish wool merchant's factor in Italy pay money to the Italian spice merchant. In effect, the Flemish wool merchant's outward cargo would have become the Italian spice merchant's return cargo, and vice versa.[128]

The system becomes more sophisticated, as was beginning to happen at the time income tax was introduced, when a merchant banker accepts (or guarantees) the bill which makes it more marketable, and a bill broker brings the parties together. A remittance was essentially concerned with delaying the timing of taxation until the goods were turned into cash in Great Britain; it did not involve the voluntary element that it now has of choosing never to remit the income.

The meanings of the second type of remittance ('sums received from property imported from thence [abroad] into Great Britain'), and the third ('sums received from money or value received in Great Britain, and arising from property which shall not have been imported in Great Britain') are clarified, as so often with income tax, by the administrative provisions. Foreign income was assessed by commissioners in London, Bristol, Liverpool and Glasgow, the main ports, as if it arose from a trade carried on there. The assessment was to be made at such port at, or nearest to, which the property was first imported into Great Britain (the second method of making a remittance), or in the case of remittances, money or value arising from property not imported (the third method) at such port at, or nearest to, which the person resided.[129] This emphasis on the ports

[127] If the estate were in the colonies the second method of making a remittance was more likely to apply for the reasons given below.
[128] J S Rogers (note125) p.33–4.
[129] 1805 Act s.CVIII, 1806 Act as a proviso in s.CXVII, and reverting to a separate section again in the 1842 Act s.108.

shows that much of the income from foreign possessions[130] was imported in the form of raw materials like cotton, and sold in Great Britain. Goods from the colonies were forced to come here by the 'Old Colonial System' deriving from the Navigation Acts 1651 and 1660 which required exports of the main raw materials, sugar, tobacco and cotton from the colonies to be sent directly to England or to another colony in English or colonial ships. They could not be exported direct to any other country. Unless, therefore, the goods went to another colony, they had to pass through Great Britain. In practice that was where the market was to be found and so they were likely to be sold here. After Independence, America was a major supplier of raw materials, particularly cotton, and purchaser of English goods, and so in practice imports from America came here too. The trade with America increased at the time because of the difficulties of doing business in Europe during the war with France.[131] Effectively therefore most foreign trade or investment resulted in goods coming to England for sale with 'sums received' here.[132] The third method of making remittances in money or value for goods not imported to be assessed at such port nearest to the place where the person resided also suggests that such remittances were connected with ports. The reference to 'money received' is the first reference to money itself (necessarily in the form of bullion) being moved, which would be through a port.[133] The reference to 'value received' may have been from barter trade, with the resident sending the produce of his foreign estate directly abroad and receiving other goods here (through one of the ports) in exchange that are turned into money here.

Perhaps the fourth type of remittance ('sums received from money or value so received on credit or on account in respect of such remittances, property, money, or value, brought or to be brought into Great Britain'), which was added in 1805, reflects the change in banking practice that evolved around

[130] We shall see that later cases restricted the scope of trading income as a foreign possession, see the heading *Trading income*, but probably all foreign income derived from trade abroad was originally thought to be income from a foreign possession.
[131] R W Hindy *The House of Baring in American Trade and Finance*, Harvard University Press, 1949.
[132] For an example of the problems this caused, see *The King v The Kensington Income Tax Comrs ex p. Aramayo* (1915) 6 TC 613 in which Lord Wrenbury said 'This case affords a striking illustration of the involved and almost unintelligible expression of the law contained in the Statutes relating to income tax.' (at p.621). The problem was that references in the provision relating to the normal place of assessment to a person engaged or not engaged in trade had to be impliedly restricted to trade in Great Britain. The charging provision for foreign income took precedence over the normal provisions. The decision was that the Kensington General Commissioners had no jurisdiction, contrary to the prevailing practice. This provision was repealed by F(No.2)A 1915 s.32(2), doubtless as a result of the case.
[133] For an account of how N M Rothschild financed Wellington's campaign from about 1811, which required movements of bullion, see Niall Ferguson *The World's Banker, the History of the House of Rothschild*, Weidenfeld & Nicolson, 1998 p.91. Again, bills of exchange were involved. Bullion was smuggled into France and used to buy bills of exchange on London at a discount which were redeemed in London at their full value.

that time.[134] Previously transactions were financed by the financier buying goods for cash and selling the goods on credit, thus acting as a merchant; later, the financiers became merchant bankers, buying bills rather than the goods.[135] This would be a way of the owner of the foreign plantation receiving money in advance of the maturity of the bill of exchange.

Thus originally the remittance basis was more of a timing provision. The profits would be remitted anyway and tax was charged when money was received here. That ceased to be true when foreign trading was no longer restricted to plantations abroad, and this led to the Revenue disputing whether the trade was a foreign trade, on which, as we have seen,[136] they were generally successful, which in turn led to taxpayers successfully countering by trading through foreign subsidiaries. The subsequent history of the remittance basis is one of gradual reduction in its scope.

Cutting Down the Remittance Basis

Investment Income

By 1914 some of the advantages of the remittance basis for taxpayers were being exploited. Accordingly a change was made designed to tax:

> ... the income that escapes taxation now owing to arrangements purposely made by men who are rich enough to leave their incomes abroad for reinvestment.[137]

This change removed the remittance basis from the easier types of income on which taxpayers could avoid tax and incidentally the easier income to compute: income from foreign securities, stocks, shares and rents.[138] Accordingly, we had now reverted to the position in Pitt's original tax but for a wider class of foreign income than for interest on foreign securities. The three-year

[134] The Rewrite said that the examples did not add anything of great value to 'sums received.' It described the third and fourth examples as particularly obscure, ED 13 (see note 8) para.1184 and they have not been included in the draft Bill.
[135] For an account of contemporary practice, see *The World's Banker, the History of the House of Rothschild* (see note 133). The young N. M. Rothschild arrived in England in about 1798 at the age of 21 operating first by buying and exporting English textiles and by 1805 was diversifying into financing imported colonial goods: 'Like his father, he was gradually shifting from being a merchant to being a merchant banker' (p.57).
[136] See *What made a possession foreign? Trading income*. See the Revenue's International Tax Handbook ITH209.
[137] Lloyd George HC Deb Vol.LXII col.89. See also vol LXIV col 1579 (Committee Stage) and vol LXV col 680 (Third Reading). See also *Singer v Williams* 7 TC 419, 430. The object of the income tax measures in the Bill was to raise a large additional sum of money without placing an undue burden on those with small or moderate incomes; this was not specifically stated to be for war, which broke out four days after Royal Assent.
[138] FA 1914 s.5. Irish income was already taxed on the arising basis, see note 16.

average still applied to income from foreign possessions.[139] The rather vague expression 'securities, stocks, shares or rents' may have been necessary because, apart from securities (Case IV) there were no Schedules or Cases that could be used to idesntify the type of income as they all fell within the single heading of foreign possessions. The benefit of being able to reinvest foreign trading profits without paying tax was not affected. The change meant that giving double taxation relief became much more important. Initially a deduction in computing the income was given for income tax paid in the place where the income arose.[140] 'Colonial income tax relief' for tax paid under the law in a British possession was introduced two years later.[141] The removal of the remittance basis from foreign investment income was subject to the important exception dealt with in the next heading. Another consequence was that UK insurance companies were adversely affected which will be dealt with below.

The dividing line between income from securities, stocks, shares and rent, and other income may have seemed clear but like all dividing lines it led to what must be the longest running dispute in the history of tax, requiring two hearings in the House of Lords, three in the Court of Appeal, and four each in the High Court and the Special Commissioners[142] to determine whether the life tenant of a trust receiving underlying income from securities, stocks, shares or rent received the same type of income as the underlying income, which meant that the remittance basis no longer applied, or a different type of income, trust income, from which the remittance basis had not been taken away. The first time round the answer was that quite reasonably the life tenant received the same type of income as the income from the underlying securities: '[the life tenant] is, in my opinion, as a matter of construction of the will, entitled in equity specifically during her life *to the dividends* upon the stocks ... .'[143] That was decided on the basis

[139] *Singer v Williams* 7 TC 419. The average included years before the change when the income had been taxed on the remittance basis. But the average could not be for years before a company became non-resident: *Bradbury v The English Sewing Cotton Co Ltd* (1923) 8 TC 481. The three-year average did not apply when dividends were paid by a paying agent, see *Singer* at p.438. For subsequent changes in the basis of assessment see note 45.

[140] FA 1914 s.5.

[141] FA 1916 s.43. This limited the rate of tax after giving relief to 3s.6d (17.5%) and was thus not of benefit to those whose tax rate was below this. See note 80 for the history of subsequent reliefs from double taxation.

[142] HL 11 TC 764, 15 TC 729; CA 11 TC 756, 15 TC 6, 712; Rowlatt J 11 TC 753, 15 TC 5, 702, 710; Special Comrs 11 TC 749, 15 TC 3, 693, 703.

[143] *Archer-Shee v Baker* 11 TC 749, 779 *per* Lord Wrenbury (my italics). The same point had previously been decided by the Privy Council on Australian legislation under which the life tenant of a trust carrying on an unincorporated business was held to be in receipt of income derived from personal services in *Syme v Commissioner* [1914] AC 1013, which was not cited. This point is subject to considerable academic debate and differs from Maitland's view of trusts. It is, however, well established that it is a proper statement reflecting the substance of the matter, which is appropriate in connection with tax. See Donovan Waters *The Nature of the Trust Beneficiary's Interest* (1967) 45 Can Bar Rev 219. *Archer-Shee v Baker* was followed in relation to an Australian trust where the life interest was subject to an annuity in *Nelson v Adamson* (91941) 24 TC 36.

that New York law, which was the governing law of the trust, was the same as English law. When the case was remitted to the Special Commissioners to find the figures, the taxpayer tried to introduce evidence that New York law was different, which they refused to hear, resulting in the intermediate trip to Rowlatt J, whose judgment running just into the third line is short even by his standards, and thence to the Court of Appeal who agreed with the Commissioners.[144] This necessitated starting again before the Commissioners in relation to a later year.[145] Even that nearly did not succeed as the Commissioners initially decided the point was *res judicata*;[146] the point then came before Rowlatt J again when the Crown waived this contention and the matter was remitted to the Commissioners to determine the case on the basis that the matter was not *res judicata*,[147] following which the case proceeded via Rowlatt J and the Court of Appeal to the House of Lords again. This time in the light of expert evidence of a professor from Columbia University Law School, the House of Lords was able to find that position of the life tenant of a New York law[148] trust was different in that she had no property interest in the underlying income; she could only compel the trustees to carry out the terms of the trust,[149] which is perhaps surprising since New York trust law is derived from English law. Such a position is not supported by writers in the United States today.[150] The taxpayer was rewarded by her perseverance by remaining on the remittance basis.[151]

The Exception to the 1914 Change

The remittance basis was retained for resident foreigners, which gave rise to difficulties of definition. Although the remittance basis is now associated with non-domiciled persons this was not the original intention as can be seen from the following stages in the progress through Parliament of the section in the 1914 Finance Bill which, subject to the following proviso,

[144] 15 TC 1.
[145] *Garland v Archer-Shee* 15 TC 693.
[146] At p.700.
[147] Re-stated case at p.703.
[148] The same finding as for a New York trust was made for a New Jersey law in *Kelly v Rogers* (1935) 19 TC 692, and an Ohio trust in *the Marchioness of Ormonde v Brown* (1932) 17 TC 333.
[149] At p.729.
[150] Scott on Trusts 4th ed §130 p.406 says 'The beneficiary of a trust has a property interest in the subject matter of the trust. He has a form of ownership. He has much more that a mere claim against the trustee, a mere chose in action. It must be remembered, however, that the chancellors at the beginning gave him no more than a claim against the trustee, and only gradually gave him proprietary rights. The growth of the trust has been a process of evolution.' Situs for US federal estate tax is determined by the situs of the underlying assets rather than the situs of the trust, see *Comr v Nevius* 76 D 2d 109 (2nd Cir. 1935) reversing 30 BTA 70.
[151] But only until 1940, see the heading *Further reduction in the remittance basis in 1940*.

Original Bill[152]	As amended in Committee[153]	As amended on Report[154]
Provided that this Section shall not apply in the case of a person who is not a British subject, nor in the case of a person who satisfies the Commissioners of Inland Revenue that being a British subject he is ordinarily resident in a British Possession.	Provided that this Section shall not apply [...] in the case of a person who satisfies the Commissioners of Inland Revenue that *he is not domiciled in the United Kingdoms.*	Provided that this Section shall not apply in the case of a person who satisfies the Commissioners of Inland Revenue that he is not domiciled in the United Kingdom *or that being a British subject he is not ordinarily resident in the United Kingdom.*

removed the remittance basis for income from stocks, shares and rents, with the new material being shown in italics.

It will be seen that neither of the current limitations to non-domiciled persons and non-ordinarily resident British subjects (now Commonwealth and Irish citizens) was in the original Bill. The non-domiciled category was introduced at the Committee Stage because the original restriction to British subjects ordinarily resident in a British Possession would cover say a Canadian (who would have been a British subject) ordinarily resident in the United Kingdom, for whom the new wording continued the remittance basis.[155] This is the first time domicile became relevant for income tax, although it was then relevant for estate duty.[156] A further, possibly unforeseen at the time, effect of changing the exception from non-British subjects to non-domiciled persons is that companies could benefit from the exception because a company can have a foreign domicile, but not be a non-British subject. The domicile of companies was unknown territory. The Income Tax Codification Committee of 1936 records that there was then no judicial authority on the point but decided that defining the domicile of a company

[152] Set out at HC Deb vol.LXIV col.1578
[153] Amendment made H C Deb Vol.LXIV col.1646.
[154] Amendment made HC Deb Vol.LXV col.516.
[155] HC Deb vol LXIV col.1622. There was no doubt some self-interest in this; those who were resident because they had houses here might otherwise have ceased to be resident.
[156] Foreign property was excluded if the deceased died domiciled outsider the UK, FA 1894 s.2(2) applying the (case law) rule for legacy and succession duty. The position was legislated in FA 1949 s.28 making the proper law relevant in addition to domicile.

was going beyond codification.[157] The first case in the UK on the point was in 1940 and decided that domicile was the same as place of incorporation.[158]

Report Stage amendments are usually a disaster and this is no exception. The relief for the non-ordinarily resident British subjects (now Commonwealth and Irish Citizens) was introduced to deal with Anglo-Indians, such as officers or civil servants on leave, who were domiciled in the United Kingdom paying short visits, and becoming resident but not ordinarily resident. An MP had argued that the original clause 'produced feelings of soreness and resentment in the Dominions beyond the seas.' It was reported that the Chancellor had entered into negotiations with representatives of the Dominions and that the Report Stage amendment had put the clause into a form that did not produce resentment, and into a form which ensured that no such charge can fairly be made against it.[159] One may indeed agree that no such charge can fairly be made against it by the Dominions; it is merely that it discriminated against everyone else. The Royal Commission of 1955[160] later very reasonably recommended that the remittance basis should be applied to any non-ordinarily resident person as the reasons which made it fair to apply it to British subjects and Irish citizens applied just as much to persons who did not have such citizenship, but nothing was ever done.[161] This provision is plainly discriminatory and must be extended to EU citizens and to citizens of countries with which we have a tax treaty containing a nationality non-discrimination provision,[162] who are domiciled in the UK (because non-domiciled people benefit from the remittance basis anyway), and so the Royal Commission's recommendation may have been achieved by another route. One wonders how many people claim the benefit of this provision today.

One of the side effects of the change was to put UK life insurance companies at a disadvantage compared to non-resident life companies. It is difficult to tax insurance companies on their profits as this requires an actuarial calculation which cannot be carried out every year, and mutual companies cannot

[157] Cmd.5131 para.66.

[158] *Gasque v IRC* 23 TC 210, following a US decision, *Bergner & Engel Brewing Co v Dreyfus* 70 American State Rep 251.

[159] Report stage, HC Deb vol.XLV col 473.

[160] Cmd 9474 para.296.

[161] Except perhaps that the relief for employment income for non-residents or non-ordinarily residents who are taxed only on work performed in the UK is not restricted by citizenship, see the heading *Employment and pensions income* below.

[162] On the lines of art.24(1) of the OECD Model Tax Convention: 'Nationals of a Contracting State shall not be subjected in the other Contracting State [the UK] to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State [the UK] in the same circumstances, in particular with respect to residence, are or may be subjected.' The normal treaty definition of UK national will include anyone who is a Commonwealth Citizen. See J F Avery Jones *et al The Non-discrimination article in tax treaties* [1991] BTR 359, 372. Personal allowances for non-residents are restricted to Commonwealth citizens and EEA nationals (TA 1988 s.278), thus preventing EU discrimination and this does not normally contravene tax treaty non-discrimination articles as personal allowances are specifically covered.

be taxed on their profits at all. Effectively they were taxed on their income;[163] accordingly relief for their expenses of management was introduced in 1915, subject to not reducing the tax below what it would have been under a Case I assessment,[164] thus introducing the I minus E method of taxing insurance companies. Relief for expenses of management compensated for their loss of the remittance basis for their foreign income, particularly when the foreign income represented reserves to meet liabilities to non-resident policyholders incurred through trading through foreign branches. A further exception was made in 1915 retaining the remittance basis for the income from foreign investments of a foreign life assurance fund of an insurance company, meaning a fund representing liabilities in respect of policies entered into through a branch or agency outside the UK.[165] This survived the ending of the remittance basis for companies generally in 1965 and was eventually ended in 1990.[166] Non-resident life insurance companies could only be taxed on the profits from the UK branch and that was difficult in practice because of the difficulty in measuring profits from life insurance. Accordingly a method of taxing them had to be introduced in 1915.[167]

Further Reduction in the Remittance Basis in 1940

A further reduction in the scope of the remittance basis was made in 1940,[168] which, like the first change of 1914[169] (and indeed, the introduction of income tax itself), was made in war time, perhaps because raising additional taxes at such times is easier. The remittance basis was restricted to trading income,[170] but only where the income was

[163] See *Clerical Medical and General Life Assurance Society v Carter* (1889) 2 TC 437 where it is clear that at the time the assessment was on the interest with no relief for expenses. The effect on insurance companies of the removal of the remittance basis in 1914 was raised in Parliament: HC Deb vol. LXIV, col.1590.

[164] See now TA 1988 s.76(2). Originally this provision applied to investment companies generally but in *Simpson v Grange Trust Ltd* 19 TC 231 the House of Lords held that it could not be applied to investment companies that could never be taxed under Case I. Subsequently FA 1965 s.69(2) restricted the rule specifically to insurance companies.

[165] FA 1915 s.16. A corresponding reduction in the expenses of management, introduced for insurance companies in s.14 of the same Act, was also made in respect of unremitted income.

[166] FA 1990 Sched. 7 para.3 substituting a new TA 1988 s.441.

[167] For the history of taxing foreign life insurance companies see *Sun Life Assurance Co of Canada v Pearson* [1984] STC 461, 490. The interaction of the internal law charge on insurance companies with tax treaties has caused problems, see the *Sun Life of Canada case and Ostime v Australian Mutual Provident* 38 TC 492.

[168] FA 1940, s.19. This change had been recommended by the 1920 Royal Commission (Cmd.615) para.27.

[169] Strictly speaking, immediately before war time, see note 137.

[170] Or income from a profession or vocation; references to trade in the text should be taken to include these.

immediately derived[171] from carrying on the trade either alone or in partnership, and to employment (including offices) and pension income. This has the effect of removing the remittance basis for cases like the second *Archer*-Shee case which, according to the Parliamentary proceedings, was the main target of the change.[172] The Solicitor-General said:

> The second category [foreign income not within the 1914 change] includes cases governed by the Archer-Shee case, which decided that income from trusts or settlements comes into the second category and therefore only income brought into this country is taxed. The hon Member is quite right in saying that the effect of the legislation to be introduced will be to put an end to that anomaly.[173]

Lady Archer-Shee, the life tenant, was an American and the trust was set up by her father's will but as she was married to an Englishman, Sir Martin Archer-Shee, she would have at the time automatically acquired his English domicile and would not therefore have been entitled to continue the remittance basis on that ground. Although not stated in the debates, a more serious anomaly than New York law trusts were trusts governed by Scots law to which the second Archer-Shee case also applied.[174] Much later, in 1993[175] in connection with the benefit of the lower rate of tax applied from that year[176] initially to dividend income, and extended in 1996 to all savings income, the life tenant of a Scots trust was deemed to have an equitable interest in possession in the underlying income, so as to be able to obtain the benefit of receiving dividend or savings income, thus bringing them into line with English trusts, just as the 1940 changes had removed the benefit of the remittance basis from Scots trusts receiving income from stocks, shares and rents as had been done for English trusts in 1914.

[171] The same words are used in the definition of earned income dating from the FA 1907 now in TA 1988, s.833(4)(c), and in the definition of 'relevant earnings' for retirement annuities dating from the FA 1956 now TA 1988, s.623(2)(c). Later decisions showed that this excluded income in respect of compensation for the nationalisation of assets in *IRC v Parkhouse Collieries* Ltd 36 TC 675; an annuity to a retired partner in *Pegler v Abell* 48 TC 564; a share of profits paid to a retired partner in *Hale v Shea* 42 TC 460; interest paid under deduction of tax to a merchant banker in *Bucks v Bowers* 46 TC 267; interest received gross on a solicitor's client account in *Northend v White & Leonard & Corbin Greener* 50 TC 121. In such cases, the derivation of the income was the Act of Parliament providing for compensation in the first case, the contract with the continuing partners in the second, or the loan in the other cases. On the other hand, a short-term gain taxed as income on the sale of goodwill of a trade was immediately derived in *Peay v Newton* 46 TC 653. The words 'immediately derived' will be dropped in the Rewrite Bill as not being necessary here, see ED 13 (see note 8) para.96.

[172] HC Deb vol.360, col.764 (budget speech); vol.361, col.1049 (Committee stage).

[173] HC Deb vol.360 col.764.

[174] *IRC v Clark's trustees* 1939 SLT 2.

[175] FA 1993, s.118.

[176] FA 1993, s.77.

The change also removed the remittance basis generally for such foreign income as interest otherwise than on securities,[177] for example bank interest, and annual payments, particularly those on separation[178] or divorce.[179]

The Introduction of Corporation Tax in 1965 and Loan Relationships in 1996

A company ceased to be taxed on the remittance basis on the introduction of corporation tax in 1965:

> ... corporation tax shall be assessed and charged for any accounting period of a company on the full amount of the profits arising in the period (whether or not received in or transmitted to the United Kingdom) ... .[180]

The second major change affecting companies was that the taxation of loan relationships from 1996 moved foreign interest to Case III so that Case IV no longer applied to companies and foreign interest otherwise than on securities is no longer taxable under Case V for companies. There are therefore now no separate rules for the taxation of foreign income from loan relationships.[181]

Trading Income of Individuals

As has been mentioned, the remittance basis ceased to apply to companies on the introduction of corporation tax in 1965.[182] It was not until 1974 (the only non-war time reduction in the remittance basis[183]) that the remittance basis was removed from trading income for the unincorporated sector subject to the same exception for non-domiciled taxpayers and not ordinarily resident Commonwealth and Irish Citizens as had been applied to investment income in 1914. As the Chancellor said in his budget speech:

> As the House knows, it has been the law for many years that, where a man goes overseas to do a job, and all the duties of the job are carried out abroad,

[177] For an example see *Lord Howard de Walden v Beck* 23 TC 384 where a series of promissory notes not carrying interest were dissected into a capital and interest element.
[178] For an example, see *Chamney v Lewis* 17 TC 318 relating to an annuity payable under an Indian separation deed.
[179] For an example, see *IRC v Anderström* 13 TC 482.
[180] FA 1965 s.51(1). This was subject to the exception mentioned above for foreign life insurance funds, see note 165. Corporation tax did not apply to income arising in a fiduciary or representative capacity so that a non-domiciled trustee company remained on the remittance basis for this.
[181] TA 1988 s.18(3A) inserted by FA 1996 Sch 14 para.5.
[182] See note 180.
[183] It was a time of significant changes in taxation including the introduction of capital transfer tax with lifetime cumulation of gifts and the estate at death, and a proposed wealth tax.

> then the earning from the job are taxable on what is called the 'remittance basis'—that is, if and when they are brought back to this country. This was, perhaps, a reasonable approach before the days of air travel and multinational companies. But under modern conditions these provisions can be, and are, used by United Kingdom residents to avoid their proper tax liabilities. For the future, it is clearly imperative that we should put a stop to the avoidance of tax by artificial devices of the kind which received so much publicity last year.[184]

One might object to the Chancellor's reference to avoidance of proper tax liabilities when it was the law that laid down that the tax liabilities based on the remittance basis were the proper ones, but one cannot object to his reference to the remittance basis being a reasonable approach before the days of air travel and multinational companies. As a compensation for the loss of the remittance basis a reduction of 25 per cent in the tax base was given which was removed in 1984 by which time tax rates were much lower.[185]

Employment Income

As with trading income there was a major reduction in the scope of the remittance basis for foreign employment income in 1974. The remittance basis no longer applied to work carried out wholly abroad, unless the income was foreign emoluments,[186] so that non-domiciled employees once again retained the remittance basis for working abroad. In addition, the remittance basis was taken away from non-domiciled employees working in the UK, the only time that the remittance basis has been removed for such persons. The Royal Commission's recommendation that working in the UK should not be a foreign employment was thus ultimately achieved.[187]

The losers, namely domiciled employees working wholly abroad and non-domiciled employees working in the UK for foreign employers, were given a reduction in the tax base. This was a 25 per cent reduction for domiciled employees, and initially a 50 per cent reduction non-domiciled employees but from 1976/77 this was reduced to 25 per cent once the employee had been resident for nine out of the preceding 10 years of assessment.[188] These reductions were repealed in 1984 by which time tax rates were much lower.[189] Thus for UK domiciled resident employees there

[184] The previous year there had been a lot of publicity to what became known as the 'Lonrho affair' during which the phrase 'the unacceptable face of capitalism' was used, and in which the remittance basis for employment income played a part.
[185] The maximum rate of tax on earned income in 1974 was 83 per cent; in 1984 it was 60%, so that the maximum rate had been reduced by more than 25% for all top rate taxpayers.
[186] See text at note 108.
[187] Cmd.9474 para.300 quoted above.
[188] FA 1974 Sch 2 para.1, 3.
[189] See note 185.

ceased to be any significant concept of foreign employment, with one exception. A further 100 per cent relief was given for working abroad for 365 days in circumstances where because this spanned two tax years the employee remained resident.[190]

Foreign pensions have been easier to categorise as foreign possessions; they were pensions paid by non-residents. The 1956 changes to employment income did not affect pensions which left all foreign pensions taxable on the remittance basis under Case V. This was also changed in 1974. UK domiciled pensioners who lost the remittance basis were given a reduction of 10 per cent in the tax base, which still continues in spite of the abolition of similar deductions for employment income. Non-domiciled pensioners remain on the remittance basis but cannot claim the 10 per cent reduction, making them worse off than domiciled pensioners if they remitted the whole pension.

Capital Gains

It should be mentioned that capital gains tax had a remittance basis from the beginning for gains on foreign assets[191] by a non-domiciled resident and no change has been made to this.[192] There has never been a relief for non-ordinarily resident Commonwealth Citizens, and, unlike income tax, there are no special provisions for Irish assets.

Proposals to Remove the Remittance Basis for Non-domiciled Persons

By 1974 the only persons benefiting from the remittance basis were non-domiciled individuals and trustees and, for income other than employment income, non-ordinarily resident Commonwealth and Irish Citizens. In 1974 a proposal was included in the Finance Bill[193] to take effect from 1976/77 to end the remittance basis completely for non-domiciled taxpayers who had been ordinarily resident for five out of the six previous years of assessment, by deeming such persons to be domiciled. On Second Reading the Chancellor proposed to change this to apply to those resident, instead of ordinarily resident, for nine out of the previous 10 years to meet the concerns that foreigners might be required to stay longer than five years for work, and also that the definition of ordinarily resident was less certain than that of resident.[194] A Government amendment to leave out the clause

[190] FA 1974 Sch 2 para.1(3).
[191] Now TCGA 1992 s.275. Short-term gains tax was the same FA 1962 s.10(6).
[192] Now TCGA 1992 s.12.
[193] Cl.18.
[194] HC Deb vol.873 col. 611–2. Explanatory note by the Inland Revenue [1974] STI 225 on the difference between residence and ordinary residence.

was agreed to without debate at the Committee Stage[195] following fierce debate outside Parliament.[196]

A second attempt was made in a Consultative Document issued by the Inland Revenue in 1988[197] suggested that a new intermediate basis of taxation between that of a full resident and a non-resident should be introduced. This would apply to non-domiciled persons who had not been resident in the UK for seven out of the previous 14 years, or, if it was not proposed to continue to use domicile as a criterion, the seven out of 14 year rule should apply only to those who had been previously non-resident for a continuous period of 10 or 15 years. The form of taxation would be to replace the remittance basis with a graduated charge depending on how long the person had been resident, although a modified form of remittance basis including all receipts was also considered. Nothing came of these proposals.

There are no examples where the remittance basis has been removed from non-domiciled individuals apart from employment income for working in the UK. There are, however, two examples of the remittance basis being made less attractive, particularly where all the income is remitted. These are the 10 per cent reduction in foreign pensions already mentioned and that the remittance basis income does not qualify for the 20 per cent rate of tax for savings income.[198]

The Future

The first and second features of the system of taxing foreign income with which we started will change with the Tax Law Rewrite. Pitt's wording will be dropped as will any remaining distinctions between Cases IV and V, and foreign income will no longer be a type of income in itself.[199] This is sad from the historical point of view but it is amazing that the wording lasted so long and the courts were able to continue to make it fit all current types of foreign income. In the Rewrite where a type of income is considered, this includes the same type of foreign income so that, for example, there is no longer any distinction between UK and foreign source interest; the charge is on 'all interest.'[200] After enactment of the Rewrite's third Income Tax Bill in the 2004/5 session of Parliament[201] there will be very few separate rules for foreign income, an example of an exception being dividends from

[195] Standing Committee A, 24 June 1974, col.584.
[196] See M A Pickering and A R *Prest Some Aspects of the Remittance Basis for the Taxation of Overseas Income* [1974] BTR 340 at 353.
[197] Residence in the UK, Inland Revenue Consultative Document, 1988.
[198] TA 1988 s.1A(4). Might these rules be discriminatory under EU law or tax treaties?
[199] ED 13 (see note 8), para.65.
[200] Draft Income Tax Bill in ED 13 (see note 8) cl.298. Similarly with all other types of income, see the list in cl.616.
[201] This date is given in the Rewrite's Plans for 2002/03, July 2002.

non-resident companies.[202] It is only necessary to define foreign income for the remittance basis and rules for unremittable income. For this purpose 'foreign income' is defined to mean 'income arising from a source[203] outside the United Kingdom which is chargeable under or by virtue of' a list of provisions, such as trading income, property income, interest etc, all of which deal with both UK and foreign income together.[204] Foreign source has the same meaning as foreign possession and so one could say that Pitt's single category of foreign income lives on under another name.

The 1955 Royal Commission approved of the remittance basis because of the large numbers of people working abroad or coming from abroad and working here in 1955 when its use was more widespread than it is today:

> Although the remittance basis for persons not ordinarily resident or domiciled in the country seems to be peculiar to the UK, we think that its employment is appropriate having regard to the conditions that govern our trade and commerce. The large overseas connections of the UK do make a special tax problem for those persons who leave for or come back from service abroad for various purposes and for various periods: conversely, there are special problems with regard to those persons who, while truly belonging to another country, are led by business interests to centre in the UK for what may often turn out to be long periods of years.[205]

The remittance basis continues in full force for non-domiciled individuals and non-ordinarily resident Commonwealth Citizens (and those other citizens who can claim it on the basis of discrimination). As this article is written, a further consultative document is awaited.[206] The Chancellor said in his 2002 Budget speech:

> The Government is reviewing the residence and domicile rules as they affect the tax liabilities of individuals. The Government believes that modernisation of these rules needs to be based on clear principles—the rules should be fair, clear, easy to operate, and support the competitiveness of the British economy. As this is a complex area, all those affected should have the opportunity to contribute to the discussion. The Government will report on this issue in time for the pre-Budget report.

How the remittance basis rates as a basis of taxing today in the age of air travel and multinational companies will be considered in relation to the

[202] Because the definition of distribution in part denies a deduction for various payments and so cannot be applied to non-resident companies: ED 13 (see note 8) para.883, and accompanying Draft Income Tax Bill cl.322. The charge is on 'dividends', an undefined expression both here and as a component to distributions of UK resident companies.
[203] ED 13 (see note 8) para.1158.
[204] Draft Income Tax Bill in ED 13 (see note 8) cl.616.
[205] Cmd. 9474 para.284
[206] Reviewing the residence and domicile rules as they affect the taxation of individuals: a background paper, April 2003.

promised consultative document. It will be interesting to see whether the outcome is any different from the previous two occasions that the issue has been raised. It is certainly a basis of taxation that is liked by foreigners working in the United Kingdom and it may be that their personal taxation is quite as important to decisions to work here as is corporate taxation. The original problems of the difficulty of measuring foreign income still continue but in different form. Probably the income needs to be measured for foreign tax purposes and so taxing it here on the arising basis would require computation on two different bases. That is particularly true of trading income but to some extent true of employment income where different methods of taxing benefits in kind, stock options etc can apply.[207] For investment income fewer problems of measurement arise, but there are still problems of measuring non-traditional income such as zero-coupon bonds, accrued income on purchase and sale of securities, and gains on life insurance policies. Perhaps the administrative arguments are just as strong. Can a tax authority really find out what a foreigner does with his assets abroad?[208] Is it not better to accept defeat and tax what one can see, rather than say one is taxing worldwide income knowing that one is not?

[207] Different countries tax options at different times and on different bases, see the OECD discussion draft Cross-border Income tax Issues Arising from Employee Stock-Option Plans, 2002.

[208] Even though the remittance basis means that these problems are limited there are still complications in operating that basis, as is illustrated by the Revenue's reasons for entering into a forward tax agreement in *Al Fayed v Advocate General for Scotland* [2002] STC 910. A minute from the Head of Special Compliance Office to the Board said that in the absence of the agreement 'we would have very great practical difficulties in actually trying to establish what the reality was' (at 920a).

3

*Income Tax Tribunals: Their Influence and Place in the Victorian Legal System**

CHANTAL STEBBINGS

ABSTRACT

STUDY OF THE income tax tribunals has so far concentrated on their nature as institutions in their own right, notably their jurisdiction, their procedures and personnel. This paper examines the place and significance of tax tribunals in the legal system in a period of substantial change and development, and in so doing addresses three issues: their place in the existing practice of administering justice through lay adjudicators; their position within the proliferating statutory tribunals; and their relationship with the formal system of regular courts. Despite a tradition of lay justice the tax tribunals are found to be perceived as instruments of the Executive rather than judicial bodies, and are seen to possess characteristics distinguishing them even from other statutory tribunals. They are seen to struggle to find a place within the formal legal system, their characteristics distinguishing them on a functional, structural and procedural level. Nevertheless a popular and official demand for a relationship with the regular legal system resulted in provision for a formal review of decisions and procedures. This in turn demanded an adherence to fundamental values of judicial behaviour, and began the modern judicialisation of these administrative tribunals.

The income tax tribunals, namely the General Commissioners and the Special Commissioners, have been the subject of some historical study. They were first examined by historians and economists, but have become the object of scholarly attention by legal historians only relatively recently. The approach has tended to be individualistic rather than collectivist – an examination of the tribunals primarily as institutions in their own right addressing fundamental

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questions about their internal working. Accordingly early research concentrated on their administration of the tax in the narrow sense, namely their assessing and collecting functions,[1] and only later were their adjudicatory, judicial, functions examined.[2] This is, of course, natural with any novel issue of academic study: the internal workings of an institution need to be understood before its wider context can be addressed. So the nature of income tax commissioners' jurisdiction, their procedures and personnel have been examined, while their place and significance as institutions in relation to the Victorian legal system as a whole forms an area of study yet to be undertaken.

Throughout most of the nineteenth century existing legal institutions became the subject of critical attention, as the demand for the rationalisation of the legal system grew. Matters of jurisdiction and personnel were debated and examined, along with issues of appeal and review, and, consequently, questions of place and position within the formal hierarchy. The demand for the rationalisation of the legal system eventually resulted in the passing of the Judicature Acts of 1873 and 1875, which gave the legal system the fundamental shape familiar to modern lawyers. It was a period of great change in the legal system, and one in which the tax tribunals, and indeed all statutory tribunals, struggled to establish their position. Their position in a wider juridical context consisted of their relationship with other judicial bodies, the extent to which they were formally part of the recognised legal system, the manner in which that position was expressed, and the nature of any control over their activities which resulted from it. Three issues are particularly prominent: their place in existing practice of administering justice through lay adjudicators; their position within the proliferating statutory tribunals of the nineteenth century, and their relationship with the formal legal system of regular courts.

The assessment of 'place' in this way is set against a background, evident in the nineteenth century and still present today, of a certain insularity in the general perception of tax matters. The public impression of tax in general, and income tax in particular, was as a specific act of government to be feared and distrusted. It was discrete, a specific grievance, and indeed the resentment occurred when the tax strayed beyond the mere paying of the impost and came to impinge on other areas of life, essentially the commercial or social standing of taxpayers, or breached their values of privacy and independence. The perception of some members of the legal profession was

[1] A. Hope-Jones, *Income Tax in the Napoleonic Wars* (Cambridge University Press, 1939); A. Farnsworth, *Addington: the Author of the Modern Income Tax* (London, Stevens and Sons, 1951); B.E.V. Sabine, *A History of Income Tax,* (London, 1966); 'The Early History of Surveyors of Taxes,' [1956] *The Quarterly Record of the Association of H.M. Inspectors of Taxes* pp.290-306; A. Farnsworth, 'The Income Tax Commissioners,' (1948) 64 *Law Quarterly Review* pp.372–388; B.E.V. Sabine, 'The General Commissioners,' [1968] *British Tax Review* 18.

[2] C. Stebbings, 'The General Commissioners of Income Tax: Assessors or Adjudicators?' [1993] *British Tax Review* 52.

similarly restrictive, that tax was not a branch of the law with which they desired to be involved. The reason was partly cultural, in that the taint of money and commerce created a tension with the perception the Bar had of itself as the higher branch of the legal profession. This notion of insularity in tax matters is still evident to some extent today, if only in the attitudes of Law Schools to the teaching of tax law to undergraduates, and in the perceptions of some students themselves. Underlying such perceptions, past and present, is the view that tax law is not law in the generally accepted sense of the term: that it is part administration, part accountancy, and only part law. Early scholars reflected this perception. Tax law was rarely addressed in general legal texts, and the analysis of tax law matters appeared in specialised journals, often with a practical character, rather than the generalist legal publications. Similarly the history of tax law seldom, and that of tax tribunals virtually never, formed part of legal history texts. The reasons for such popular and professional attitudes must be the subject of separate examination, but in this study which seeks to ascertain the place of the tax tribunals from a doctrinal perspective rather than a social or socio-legal one, it forms a revealing and important context. If the perception of income tax was as an institution which was not, and should not be, integrated into personal and professional legal life, it remains to be seen how far this perception was reflected in the formal legal organism of nineteenth century England.

A number of approaches could be adopted to ascertain the place of the income tax tribunals in the legal system; their procedures, personnel, their jurisdiction or powers, and the nature of their functions could be compared to those of other, overtly judicial, bodies. While this would be a valid approach to the precision of judicial or administrative character, it would be in essence an internal categorisation of the institution, rather than an external determination of place. One possibly effective method of assessing the position of the income tax tribunals in the legal system is to examine the extent to which the decisions of the tax tribunals were subject to revision by the superior courts of law. This includes powers of appeal in the strict sense, namely the power of another court to substitute its own decision for that of the tax tribunal, and the power of review properly so called which involves merely the power of the court to quash the decision of the original tribunal. This formal relationship with the regular courts places the tribunals in their wider juridical context.

The General Commissioners, created in 1799[3] were unambiguously lay bodies. They were appointed by the Land Tax Commissioners from among themselves, the only criteria being the property qualifications required by the statute. They were accordingly relatively wealthy men, of some social standing within their community, often involved in commerce, whose sense of civic duty led them to undertake this unpaid public service. In practice

[3] 39 Geo. III c.13 (1799).

they were drawn from the same class from which the Justices of the Peace were appointed. Their local knowledge of commercial matters was regarded as essential to the carrying out of their duties, which comprised the formal assessment to income tax under Schedules A, B and D, and the hearing and determining of appeals against those assessments. The latter function was judicial in nature, and formed the basis of any claim to a place in the formal legal system. Special Commissioners, created in 1805,[4] were salaried civil servants appointed by the Treasury to undertake very specific administrative duties initially of exemption and assessment under Schedules A and C,[5] and later of assessments on foreign and colonial income,[6] and, if the taxpayer so elected, of assessment and appeal under Schedule D.[7]

As lay persons exercising judicial functions, the tax commissioners were familiar creatures of the nineteenth century. The use of lay adjudicators in the administration of the law had a long tradition. The prime examples were the jury and the Justices of the Peace, and both were regarded not only as part of the formal legal system, but as essential elements in its operation. The jury was one of the great safeguards of the common law. It was regarded as 'the constitutional tribunal for trying issues of fact,' the theory being that all questions were fit to be tried in that way.[8] Although in the nineteenth century there was increasing criticism of the jury as a fact finding body,[9] it maintained its place as the prime arbiter of facts, and strengthened the traditional view that questions of fact could not only be decided by lay bodies, but indeed were best decided by them. Thus the jurisdiction of the General and Special Commissioners, whose duties in adjudicating appeals against assessments to income tax largely consisted of determining issues of fact, was regarded as both proper and highly desirable. The Justices of the Peace, unpaid local landowners with no formal legal knowledge, ultimately became the principal law enforcement agency in the provinces, with extensive criminal jurisdiction exercised at Special, Petty and Quarter Sessions.[10] They constituted the face of the administration of justice in the eyes of the great proportion of the population. Arbitration, the private

[4] 45 Geo. III c.49 s.30 (1805).
[5] 45 Geo. III c.49 s.30.
[6] 46 Geo.III c.65 s.31(1806); 5 & 6 Vict. c.35 s.23 (1842).
[7] 5 & 6 Vict. c.35 s.131 (1842); Minutes of Evidence before the Select Committee on the Income and Property Tax, *House of Commons Parliamentary Papers* (1851), vol.ix (1), qq.1036ff, q.1311, Command 354; Minutes of Evidence before the Royal Commission on the Income Tax, *House of Commons Parliamentary Papers* (1919–20), vol. xxiii, qq.13,781–83, Command 288–4.
[8] See the First Report of the Judicature Commissioners, *House of Commons Parliamentary Papers,* (1868–9) vol.xxv p.12, Command 4130; W. R. Cornish and G. de N. Clark, *Law and Society in England 1750–1950,* pp.19–21.
[9] See the First Report of the Judicature Commissioners, *House of Commons Parliamentary Papers,* (1868–9) vol.xxv p.18, Command 4130.
[10] Elie Halevy, *A History of the English People in 1815*, (Ark Paperbacks edition, London, 1987) pp. 33–34.

settlement of disputes by the appointment of arbitrators selected by the parties themselves, formed another aspect of lay adjudication which was particularly influential in the growth of statutory tribunals generally. It was widely used in the nineteenth century, and while it possessed the character of agreement rather than adjudication, and as such was removed from the formal legal system, it was a commonly accepted alternative, often one provided by statute, for the settlement of disputes, especially those with a financial element.[11]

Another leading characteristic of the General and Special Commissioners was their limited sphere of operation. As their full names indicate, they were created for a specific task, namely the implementation of the income tax legislation. In this too, they were not unusual in the nineteenth century. Specific jurisdiction was both commonplace and fully integrated into the legal system through the numerous and popular courts of specialised jurisdiction.[12] The Lord Mayor's Court of London, the Stannary Courts of Devon and Cornwall, the Salford Hundred Court and the later Courts of Requests were just some examples. Though part of the legal system, they were acknowledged to be 'exceptional and intermediate,' and their abolition was recommended by the Judicature Commissioners in 1872.[13]

Finally, the combination of judicial and administrative functions was not peculiar to the income tax commissioners. Justices of the Peace were nothing less than the instruments of local government, whose administrative functions in some periods rivalled, if not exceeded, their judicial ones.[14] Their administrative duties included the making of rates, the supervision of roads and bridges and the licensing of ale houses. Furthermore the specific use of bodies with such features in the tax sphere was not new, for while the concept of an involuntary tax on income was novel, the machinery was not. William Pitt had simply adopted the model of the Land Tax Commissioners.

The leading features of the income tax tribunals – their lay personnel, their specialised jurisdiction, their combination of administrative and judicial duties – did not, therefore, preclude them from claiming a place in the formal legal system. Other institutions which shared one or more of these features were accepted by the public, the legal profession, the judiciary and the Legislature as component elements of the recognised legal system in the

[11] There were problems associated with arbitration: delay, expense, lack of judicial expertise, absence of appeal, no uniformity and a danger of manipulation. See the First Report of the Judicature Commissioners, *House of Commons Parliamentary Papers,* (1868–9) vol.xxv p.13, Command 4130.

[12] See generally W. R. Cornish and G. de N. Clark, *Law and Society in England 1750–1950,* pp.29–33; H.W.Arthurs, '*Without the Law:' Administrative Justice and Legal Pluralism in Nineteenth-Century England* (Toronto, 1985) pp.16–34.

[13] Second Report of the Judicature Commission, *House of Commons Parliamentary Papers,* (1872) vol.xx 217 at pp.18–19 of the Report, Command 631.

[14] W. R. Cornish and G. de N. Clark, *Law and Society in England 1750–1950,* p.21.

nineteenth century. So, for example, it was because the Justices of the Peace were perceived as a judicial authority that they endured at all.[15] Some such institutions even survived the recasting of the legal system by the Judicature Acts of 1873 and 1875, and emerge strengthened in their position by the successful weathering of close and public scrutiny.

An alternative perspective on the General and Special Commissioners is to examine them in the context of the growth of lay statutory tribunals in the nineteenth century. The early nineteenth century saw a real concern for social reform which permeated the governing classes. The thorough investigation which followed the discovery of some social evil resulted in proposed reforms, embodied in legislation, and considerably extending the scope of central government interference. These reforms each had a very different provenance, in that they were introduced with their own specific purposes, but most were a direct result of the agrarian and industrial revolutions of the eighteenth and early nineteenth centuries and operated in the sphere of social welfare – factories, public health, mines, education, the relief of poverty and so on. The new legislation had to be implemented, and, in view of the inadequate administrative machinery of the early Victorian age, this was undertaken by a number of *ad hoc* central bodies called Commissions, or Boards, appointed especially for the purpose.[16] The reasons for the setting up of these bodies were not entirely negative: there were positive requirements for the handling of a large number of small cases with speed, informality, low cost and, above all, specialist expertise, which the regular courts could not provide and specially constituted lay bodies could. In administering the new legislation, however, disputes between private individuals and the government bodies would arise, and the necessary powers of dispute resolution were given to those organs. State intervention, therefore, brought with it the determination of disputes by adjudicating bodies lying outside the traditional court hierarchical structure and staffed not by judges, but by panels of civil servants, of bureaucrats. If such bodies had not been empowered to hear and determine disputes, then the task would have fallen either to the regular courts of law or to the Executive itself.

The income tax tribunals, and their direct predecessors, predated the expansion of central government and the consequent growth of tribunals that were essentially administrative in nature, for that movement began in earnest in the 1830s. Nevertheless, they appear to sit comfortably within this paradigm, and this is particularly true of the Special Commissioners who were appointed by the Treasury and who included, *ex officio*, the members of the Board of Inland Revenue. Both General and Special

[15] See S. and B. Webb, *English Local Government from the Revolution to the Municipal Corporations Act* (London, 1924) p.606.
[16] An early example is the Poor Law Board, set up by 4 & 5 Will. IV c.76 in 1834.

Commissioners were conceived as institutions of local government, formed purely for the executive purpose of implementing fiscal legislation.[17] They did possess the undoubtedly administrative function of making assessments, even though only formally, to income tax, and their adjudicatory function of determining appeals against those assessments, while arguably judicial, could equally be said to be simply the last step in the ministerial assessment process.[18] The judicial function served the administrative one, and *prima facie* that determined the nature of the tribunal.

Nevertheless the possession of characteristics in common with other institutions which held a recognised position in the formal judicial system accordingly places the income tax tribunals in the general context of lay justice and alternative dispute resolution. While they possessed a cultural place in the legal system in its widest sense, their formal place can be ascertained by examining the extent to which appeals were allowed from their decisions to the regular courts. The subjecting of the judicial determinations of the income tax tribunals to a right of appeal to the courts of the established legal hierarchy created a recognised bond between the unstructured and somewhat random statutory tribunals and the stability of the formal legal system. Such a relationship created a place, albeit an inferior one, for the institutions possessing such powers.

The right of appeal, in the sense of submitting a complaint to another and consequently superior body, that the decision of the original body was wrong in fact or law, was not a right allowed by the common law and was unusual in the eighteenth and early nineteenth centuries. Indeed, at common law there was a presumption the other way. Appeals were not thought necessary within the formal legal system, because a jury was generally involved in both civil and criminal trials, and, as has been seen, juries were regarded as the best, and accordingly the final, arbiters of fact.[19] Questions of law, on the other hand, were felt to be the province of the judges. The small size of the judiciary and its high standing resulted in such issues being left to it with confidence.[20] Appeals could therefore only be permitted by express provision. The statutory powers of appeal from tribunals to the superior courts are accordingly revealing as to the legislative perception of the place of the former in the legal system.

Provision for appeal within the system of superior courts grew throughout the nineteenth century, and while at first they were 'various and discordant,'[21]

[17] See B.E.V. Sabine, 'The General Commissioners,' [1968] *British Tax Review* 18.
[18] For a later statement of this view, see *Commissioners of Inland Revenue* v. *Sneath* (1932) 17 T.C. 149 at 168, *per* Romer L.J. See generally C.Stebbings, ' "A Natural Safeguard;" The General Commissioners of Income Tax,' [1992] *British Tax Review* 398.
[19] See H.J. Stephen, *New Commentaries on the Laws of England* (London, 1844) vol. III, pp.622–623.
[20] H.J. Stephen, *New Commentaries on the Laws of England* (London, 1844) vol. III, p.622.
[21] First Report of the Judicature Commissioners, *House of Commons Parliamentary Papers* (1868–9) vol.xxv 1 at p.23 and see pp. 20–23, Command 4130.

by the latter part of the century the Judicature Act of 1873 provided that an appeal was to lie from every judgment and order of the High Court, and established the appeal by motion as the one uniform method.[22] Appeals were generally provided to lie to the superior courts from inferior courts such as the County Courts and the Quarter Sessions, and when from the 1830s, when the growth of central government gave rise to numerous new tribunals in a variety of specialist fields, the statutes creating these bodies generally made provision for appeal from at least some of their determinations. Though the nature and extent of the powers of appeal were as diverse as the tribunals themselves, the underlying view was that inferior courts and lay tribunals were, like juries, the best bodies to decide questions of fact, but that their constitutions and the interests of the law itself made it desirable that there should be the possibility of appeal to the superior courts on questions of law. It was felt that the need for the superior courts to supervise and control the decisions of inferior courts was 'so great and so obvious,' in order 'that the law in its principles and practice may flow in an uniform and continuous channel from the fountain head.'[23] Just as the Legislature revealed its views of the place of statutory tribunals in the legal system through its statutory provisions for appeal, so the public made known its perceptions of place through its demands and expectations in relation to powers of appeal.

There was undoubtedly a demand for the right of appeal to another, implicitly higher, body, in relation to the new tribunals of the nineteenth century. The evidence reveals a strong correlation between the status of the tribunal personnel, the nature and extent of their powers, and the demand for powers of appeal. The more highly qualified the members of the tribunal, the greater the confidence of the parties in the correctness of the decision and the less the demand for appeal powers. The lower the status and the greater the powers, the more the suspicion of error, and the higher the demand for appeal provisions. So, for example, the powers given to bodies of lay commissioners in the compulsory commutation of tithes in 1836,[24] the voluntary enfranchisement of copyhold in 1841,[25] and the voluntary inclosure of common land in 1845[26] were extensive. These three legislative regimes all sought to restructure private property rights, and, other than in tithe commutation, sought to do so voluntarily. So complex was the subject-matter, and so far-reaching were the powers in the hands of bureaucrats[27]

[22] Supreme Court of Judicature Act 1873 (36 & 37 Vict. c.66) s. 19
[23] Report of the Royal Commission on Bankruptcy, *House of Commons Parliamentary Papers* (1854) vol. xxiii 1 at p.38, Command 1770.
[24] Tithe Commutation Act 1836 (6 & 7 Will. IV c.71).
[25] Copyhold Act 1841 (4 & 5 Vict. c.35).
[26] Inclosure Act 1845 (8 & 9 Vict. c.118).
[27] For example, the Inclosure Commissioners had the power to determine disputed boundaries, and these decisions could be of immense importance. Where the right to minerals was concerned, a difference of some two or three hundred yards in the setting of a boundary could involve several thousands of pounds: Minutes of Evidence before the Select Committee on Commons' Inclosure, *House of Commons Parliamentary Papers*, (1844) vol. v at 1, qq 4679–4687, Command 583.

that a number of safeguards had to be provided by the governing statutes in order to gain public confidence and thereby achieve the aims of the Legislature. After all, unlike the regular courts, the new tribunals had no tradition of public confidence in their proceedings. The regular courts possessed all the in-built safeguards of an expert and ancient profession of high status, established and tested procedures, and independence, while the new bodies comprised laymen who were experts in their specific field of operation but not in law, with lax, often non-existent procedures and extensive discretionary powers. While, therefore, there was some difference of opinion as to whether appeal should be to the regular courts, or to a central and specialised tribunal in London,[28] the consensus was that the former was the most desirable; a summary process in the hands of lay commissioners with no intervention of a regular and authoritative court of law at any stage was felt to be unacceptable.

Of course it was not always in the interests of the state to allow appeals, primarily because it would enable wealthy and litigious parties considerably to hinder the implementation and progress of government policy. Other disadvantages included the absence of relevant expertise in the regular courts. 'You cannot appeal upon anything except law,' it was said in relation to railway matters, as 'you have no cognate court to appeal to.'[29] Specialist expertise was indeed one of the very reasons why certain legislation was given to new tribunals. When in 1854 it was proposed that the regular courts should be given the task of implementing the new railway legislation, Lord Campbell forcefully observed that it sought to turn the Judges of the courts of common law into railway directors and that the subject matter had nothing at all to do with law: it was not judicial in character, but purely ministerial.[30] The greatest disadvantage, however, was that of the inevitable increase in expense when appeals were allowed, again undermining one of the reasons for the creation of tribunals in the first place. Traders, for example, objected to the right of appeal given to the Railway Commission because they knew that the railway companies would fight a case through every court open to them, and feared the potential escalation of costs. And again, appeals led to delays. Indeed, the right of appeal was seen by some lawyers as contrary to the spirit of summary justice.

The contribution of appeal provisions to the popular acceptance of the tribunal in question, however, was appreciated, and the Legislature generally took a pragmatic and politically expedient view. Accordingly, while the

[28] See for example the diversity of opinion in relation to inclosures: Minutes of Evidence before the Select Committee on Commons' Inclosure, *House of Commons Parliamentary Papers* (1844) vol.v p.1, qq. 400; 655;1107–8; 1458; 2633; 2636;4050–60;4363;4679–87, Command 583.
[29] Minutes of Evidence before the Select Committee on Railways, *House of Commons Parliamentary Papers* (1881) vol.xiv, q.9382, Command 374–1.
[30] *Parliamentary Debates,* series 3, vol.133, col.596, 19 May 1854 (House of Lords).

primary safeguard which the Legislature provided in response to popular anxieties as to adjudication by lay commissioners was that of publicity,[31] it recognised that the ultimate precaution against incompetence, error and mismanagement, and the one which was of profound significance to the popular acceptance of the entire machinery, was the right of appeal to the regular courts of law.

The tithe commutation of the 1830s, carried out by the Tithe Commissioners, was an outstanding success, even though it was an early instance of compulsory state intervention in private affairs. A number of factors contributed to this,[32] not least the strong element of local and personal control inherent in the process, but material in achieving success was the provision of generous powers of appeal. The commissioners' determinations of boundary disputes, for example, were subject to a right of appeal, and the mode laid down by the statute was that of feigned issue[33] to the next Assizes,[34] and if the appeal concerned a question of law only, and the parties were agreed as to the facts, the party could request a case to be stated for the opinion of a court of law.[35] Their power to settle disputed parochial boundaries at the request of a parish was subject to an appeal by *certiorari* to the Court of Queen's Bench.[36] These were generous and robust appeal provisions to high level courts, and compared well to appeal provisions in other administrative tribunals.[37] When in 1852 copyhold enfranchisement was made compulsory at the request of either party,[38] an informed objection to the finality of the commissioners' decisions in questions of law and fact[39] resulted in the retention of the appeal provisions on the model of that of the Tithe Commissioners.[40]

The private inclosure Acts from which the procedure of the new centralised processes of 1845 were taken provided for appeals from the Inclosure Commissioners' decisions as to the setting out of roads, for example, to the commissioners and local Justices of the Peace, who were to 'hear and determine' such disputes 'to the best of their Judgement,' an expression redolent of tax administration statutes. Any decision to stop a road entirely had to be made with the concurrence of two Justices, but was subject to

[31] Achieved through a system of public notice and public meetings throughout the process.
[32] Essentially the process was admirable: it was inclusive, flexible, well informed, sensitive and yet independent.
[33] A feigned issue was a mode of deciding questions of fact, whereby the parties stated they had made a wager as to the truth or otherwise of a proposition, set out the facts, and the issue was determined by a jury. It was abolished in 1845.
[34] 6 & 7 Will. IV c.71 s.46, if the yearly value of the payment in question was more than £20.
[35] 6 & 7 Will. IV c.71 s.46.
[36] 7 Will. IV & 1 Vict. c.69 s.3.
[37] The appeal provisions in relation to copyhold commutation and enfranchisement were identical: 4 & 5 Vict. c.35 s.40.
[38] Enfranchisement of Copyholds Act 1852 (15 & 16 Vict. c.51).
[39] *Parliamentary Debates*, series 3, vol.120, cols.965–6, 21 April 1852 (House of Commons).
[40] 15 & 16 Vict. c.51 s.8.

appeal to the Quarter Sessions,[41] as were the all important boundary determinations.[42] Under the 1845 Act, where much of the day to day inclosure process was carried out by a 'mere valuer' rather than the centrally-appointed Commissioner, the need for effective appeal procedures was especially necessary. In the specific instance of stopping up roads and exchanging lands, there was an appeal against the valuer's decisions to the Justices of the Peace at Quarter Sessions,[43] the matter to be settled by a jury. A party aggrieved by the determination of the commissioners as to a claim could choose to appeal to a superior court of law by feigned issue at the next Assizes,[44] or alternatively submit the issue to arbitration.[45] The appeal provisions in relation to boundary determinations were particularly robust, possibly to make the resolution of such potentially important property rights by a central board more acceptable. The appeal to Quarter Sessions was replaced with a choice between the determination of a jury on the matter presided over by an Assistant Commissioner, or an application to the Queen's Bench to remove the determination by *certiorari*.[46] There was thus, in 1845, an alternative appeal procedure, though both entailed considerable expense. If the appellant chose the *certiorari* route, the decision of the Queen's Bench was to be final and conclusive as to the boundary.[47] Such, therefore, was the importance of the determination of property claims in the context of inclosure, that a three-tier system of decision and appeal was provided by the Act, comprising all the known methods of dispute resolution – lay tribunal, jury, the regular courts of law, and arbitration. Despite the fear of litigation, there was some discomfort at expressly preventing parties from having recourse to the courts of law to sustain their rights if that is what they chose to do, and the view that a system of arbitrary determination should replace the regular courts of law was a minority one in the early Victorian period. In practice, and as was shown by the operation of the Tithe Commissioners, if the tribunal was a competent one there would be little recourse to the regular courts under the appeal provisions, but nevertheless the fear prevailed that if appeal provisions were too generous there would be such a flood of litigation that the implementation of government policy would be materially hindered.

Similarly in relation to railways, where the interests concerned were of considerable financial importance, rights of appeal were a highly contentious issue. It was felt that where issues of such magnitude were being decided, the tribunal should be strong in legal knowledge and ability; if this

[41] 41 Geo III c.109 s.8.
[42] 41 Geo III c.109 s.3.
[43] 8 & 9 Vict. c.118 ss.63, 64.
[44] 8 & 9 Vict. c.118 s.56.
[45] 8 & 9 Vict. c.118 s.60.
[46] 8 & 9 Vict. c.118, s.39.
[47] 8 & 9 Vict. c.118, s.44.

was not so, then there should be the widest right of appeal.[48] When the new Railway Commissioners were created in 1873, the denial of any right of appeal from their decisions was strongly resented by the railway companies. 'It was not to be reasonably supposed,' it was argued, 'that the Railway Companies would submit their interests to any body of gentlemen, however, distinguished, without appeal.' To do so would be 'to establish a sort of Railway Star Chamber,[49] capable of interpreting its own jurisdiction on the most elastic principles.'[50] The strength of the railway interest in Parliament resulted in the granting of a right to appeal by way of case stated on a point of law to the Queen's Bench.[51] There was no appeal on a question of fact.

So where, in this general context of appeal provision, did the income tax tribunals lie? The decisions of the Land Tax Commissioners, who heard appeals from the assessments to the land tax made by the Assessors and on whom the General Commissioners were modelled, were expressly provided to be final 'without any further appeal upon any pretence whatever.'[52] The finality of their determinations ran through the whole Land Tax, since their decisions as to distress, and on all questions touching the rates, duties, assessments or collections were equally expressly provided not to be questionable in any court.[53] The Land Tax Commissioners had, therefore, no formal place in the legal system,[54] constituting instead a self-contained structure of tax administration and appeal, albeit a small one.

By contrast an appeal to the High Court had long been permitted in the context of the assessed taxes even though that tax employed the same administrative and adjudicatory machinery as the land tax, namely, the Land Tax Commissioners. This power was widely used, and the resulting case law was extensive.[55] The appeal was allowed only on a point of law and was to be by way of case stated. This method of appeal built on the common law tradition of leaving questions of fact to be decided finally by the jury, while allowing in some limited instances a review on a question of

[48] This was so in respect of the Railway Commissioners, who heard cases of great financial importance: *Parliamentary Debates,* series 3, vol.312, col.142, 14 March 1887 (House of Lords).
[49] A very common phrase – the General Commissioners are often called Star Chambers in the popular press.
[50] *Parliamentary Debates*, series 3, vol.215, cols, 367–8, 31 March 1873 (House of Commons).
[51] See speech of Mr Denison in debate on the Railway and Canal Traffic Bill, *Parliamentary Debates*, series 3, vol.215, cols, 367–8, 31 March 1873 (House of Commons). Nevertheless the railway companies felt it was still insufficient; they wanted the same rights of appeal as those given to the superior courts by the Judicature Act of 1873, namely the right to appeal to the Court of Appeal.
[52] 38 Geo.III c.5 s.8.
[53] 38 Geo. III c.5 ss.17, 23.
[54] Though see 1 & 2 Vict. c.58 (1838).
[55] See generally W.R. Ward, *The Administration of the Window and Assessed Taxes 1696–1798,* (Phillimores, Canterbury, 1963).

law to a court of high standing, and a popular procedure for enabling this to be done. It was a well established alternative to express statutory appeal which allowed the decision of a judge and jury at *nisi prius* to be reviewed through argument before the full court at Westminster.[56] It was known as the 'special case'[57] procedure, and it was widely used in tax cases. When the establishment of County Courts in 1842 was debated in Parliament, Lord Wynford believed that as to appeals 'the best which could be devised would be to follow out the practice of the tax acts, by drawing up special cases in small causes, and then there would be a uniformity of proceeding.'[58] When the Legislature decided to allow an appeal on a point of law in the assessed taxes, it was natural for it to do so by way of case stated, the statutory version of the special case. The procedure was, furthermore, well suited to a lay adjudicatory body which was not a court of record and which decided questions of both fact and law. The case stated procedure was phrased purely in terms of a question of law – whether the determination was contrary to the 'true Intent and Meaning of [the] Act' – being put to the judges for their opinion at the request of one or other of the parties. The result was not that the commissioners' determination should be quashed, but that it should be amended or confirmed in the light of the judicial finding.[59] This provision for an appeal by way of case stated was to be read into, or else was reproduced exactly, in a number of later Acts.[60] The effect was to give a comprehensive right of appeal to the superior courts of Common Pleas, King's Bench or Exchequer against the determination of the commissioners implementing the various assessed taxes.

When the income tax was introduced in 1799, the Act did not follow the precedent of the assessed taxes in relation to appeal provision, but preferred the model of the land tax[61] and forbade any further appeal to the courts of law. Though the Act of 1799 did not expressly provide, as the Land Tax Acts did, that the decision of the then appellate body, the Commissioners of Appeal, was final, the administrative powers granted by an early Taxes Management Act of 1798[62] were to be read into the 1799 Act, and that Act

[56] The predecessor of the modern Divisional Court.
[57] See generally Editors of the Law Student Magazine, *A Compendium of the Practice of the Common Law* (London 1847) pp.383–384; M.J. Pritchard, 'Nonsuit: A Premature Obituary' [1960] *Cambridge Law Journal* 88 at 92–96.
[58] *Parliamentary Debates*, series 3, vol.65, col.238, 18 July 1842 (House of Lords).
[59] 21 Geo. II c.10 s.10.
[60] See, for example, the tax on servants imposed by 17 Geo.III c.39 (1777), ss.21, 22; the tax on houses imposed by 18 Geo.III c.26 (1778), ss.41, 42; the tax on female servants imposed by 25 Geo.III c.43 (1785) ss.38, 39. In some instances, where the Act itself contained no appeal provisions, as with the tax on horses and carriages in 29 Geo.III c.49, the tax was expressed to come under the provisions of a taxes management Act of 1785 (25 Geo.III c.47) which itself provided by ss. 33 and 34 that the decision of the Commissioners was final, subject to an appeal by way of case stated.
[61] 38 Geo. III c.5 s.8.
[62] 38 Geo. III c.16.

provided that the determination of the commissioners on appeals by aggrieved taxpayers 'shall be final.'[63] The General Commissioners, the Commercial Commissioners and the Commissioners of Appeal of 1799 were thus conceived as a self-contained organism lying almost entirely outside the formal legal system.[64] The reasons for denying any right of appeal to the regular courts along the lines of the assessed taxes were not expressed in contemporary debate. The new tax was immensely unpopular, and while a power of appeal might have helped to lessen the resentment, the depth of the antipathy might have resulted in so many appeals as to paralyse the tax in practice. The assessed taxes had been equally unpopular,[65] but they were in essence voluntary, and could be avoided by not purchasing the items subject to the tax; the novelty of the income tax was that it was mandatory, and accordingly an appeal offered the only legitimate means of escaping liability. Pitt offered other concessions, namely a requirement for the blandest of returns, stringent qualifications for the commissioners, oaths of secrecy and special provision for commercial income, but he was steadfast in withholding the power of appeal to the regular courts.[66]

When in 1803 the General Commissioners took on adjudicatory functions by becoming the supreme appellate body, though retaining a formal assessing function, they potentially acquired a position in the legal system.[67] Their principal appellate duty was to hear appeals against assessments made by the Additional Commissioners under Schedule D,[68] a schedule which was then both very wide in scope and of particular importance. Alongside the substantive Act which gave them these powers, there existed a management Act,[69] passed in the same session, whose powers were to be read into the substantive Act, and which constituted the machinery for putting the Income Tax Act into operation. The management Act was rather more informative as to the status of commissioners' determinations. It provided that the appeals heard and determined by the commissioners were final and could not be altered, 'except always in such Cases where the Opinion of the Judges shall be required according to the Provisions of any Act or Acts concerning the same.'[70] In the case of income tax, however, there were no such provisions. The Act of 1803, therefore, continued the policy of its predecessor of 1799. The Special Commissioners were initially given no adjudicatory duties, but when they were empowered to hear

[63] 38 Geo. III c.16 s.54.
[64] There was, of course, the possibility of a special case at common law, and of judicial review.
[65] W.R. Ward, *The Administration of the Window and Assessed Taxes 1696–1798,* (Phillimores, Canterbury, 1963) pp.15–16.
[66] He did not even permit an internal appeal from the decisions of the Commercial Commissioners.
[67] 43 Geo. III c.122.
[68] 43 Geo. III c.122 s.144.
[69] 43 Geo. III c.99.
[70] 43 Geo. III c.99 s.29.

appeals against certain Schedule D assessments, their determinations were not subject to any appeal to the regular courts, though certain internal review procedures existed.

In the tax sphere, therefore, the policy as to appeals was not consistent. Appeal was allowed in relation to the assessed taxes, but not in relation to the land tax nor to the income tax. Clearly the common law tradition of the special case and the statutory tradition of the case stated for assessed taxes were insufficient to force a similar mode of appeal in income tax. The reason for the continued denial of rights of appeal were undoubtedly based on public policy. Even in those tax Acts which gave a right of appeal, as in the assessed taxes, it was clearly intended that the right be strictly limited. In 1848 Parke B. observed in relation to a tax on horse dealers that if the right of appeal were not limited, there would be a 'flood of litigation.' 'Actions would be innumerable,' he continued, 'juries would have to decide on facts without end, judges on law, and cases would be carried to the highest tribunal, when the exigencies of the state required a speedy determination.'[71] The object of any tax was to raise revenue, and to do so quickly and consistently, an objective which was threatened by extensive appeal powers. Appeals were also regarded as less necessary where the statute had established a multi-tiered tribunal structure within a particular field, a self-contained judicial system in its own right. Though the income tax tribunals were only two-tiered, that argument was applied to them. Cost too was an inhibiting factor to the granting of rights of appeal to the courts. To allow appeals would inevitably increase the expense to the litigating parties, particularly where the Crown wished to pursue a point of principle, and would result in delays and formality, thereby undermining the very reasons for the creation of such tribunals.[72]

There were, nevertheless, cogent reasons why appeals should be permitted to the regular courts on questions of law, and a corresponding demand.[73] In carrying out their statutory duty to hear and determine appeals against assessments, [74] the General and Special Commissioners were deciding questions of both fact and law. The suitability of the General Commissioners to decide questions of fact was largely unchallenged: it was consistent with the common law tradition of lay bodies being the final

[71] *Allen v Sharpe* (1848) 2 Ex. 352 at 363@. See too Platt B. at 367.

[72] This was particularly important in tax matters, where the Executive would pursue a case to the highest court where a matter of principle was involved: See Report of the Royal Commission on the Income Tax, *House of Commons Parliamentary Papers* (1920) vol. xviii, para.594, Command 615; Final Report of the Royal Commission on the Taxation of Profits and Income, *House of Commons Parliamentary Papers* (1955–6) vol. xxvii, para.933, Command 9474.

[73] *Parliamentary Debates*, series 3, vol.127, col.537, 23 May 1853, (House of Commons); Minutes of Evidence before the Select Committee on the Income and Property Tax, *House of Commons Parliamentary Papers,* (1851), vol.ix (1), qq.1548, 1554, Command 354.

[74] 43 Geo. III c.122 s.144.

arbiters of fact, and was strengthened by the view that local knowledge was essential to the fair determination of facts,[75] information which only the General Commissioners could have. Furthermore the finding of facts involved assessing the credibility of witnesses, and that could not be determined from written notes.[76] It was quite different, however, in relation to questions of law. The lay and untrained General Commissioners were assisted in this respect by a clerk, but he did not have to be legally qualified,[77] and while most issues for determination were questions of fact, some questions of law arose which were of particular complexity. It was generally recognized that the General Commissioners often had great difficulty mastering such questions.[78] 'There is no power,' complained a Surveyor in 1851, of going beyond the general commissioners, which I think is an unfortunate part of the Property Tax Act; because, if the same power were given as under the assessed taxes, of appeal to some superior tribunal, it would remove a great many difficulties which now present themselves.'[79] If the Crown officer, the Surveyor, felt the decision was contrary to law, he could do nothing about it. The Special Commissioners were better suited to determining questions of law, being full time civil servants and accordingly highly experienced.

By the 1870s, when a general and uniform power of appeal had been given to the regular courts, and many tribunals had been given powers of appeal on certain specified issues, even though there was no underlying consistent principle to the granting of appeal powers to these inferior bodies, the advantages of such powers were better appreciated. It was understood that they introduced a measure of uniformity among adjudicating bodies which had little in common other than their statutory creation, specialist subject matter and lay constitution, and also could have a salutary effect on the quality of the administration of the law by providing a check on their proceedings and a measure of external discipline.[80] In the context of the

[75] A view which began to weaken by the 1870s.

[76] Minutes of Evidence to Second Report of the Judicature Commissioners, *House of Commons Parliamentary Papers* (1872) vol.xx, p.245, Command 631(Volume 2, Answers to Questions). See too Report of the Royal Commission on the Income Tax, *House of Commons Parliamentary Papers* (1920) vol.xviii para.590, Command 615.

[77] The only requirement for appointment was that he should be a 'fit' or 'fit and sufficient' person': 39 Geo. III c.22 s.23; 43 Geo. III c.99 s.9. See generally C.Stebbings, 'The Clerk to the General Commissioners of Income Tax,' [1994] *British Tax Review* 61.

[78] See for example Minutes of Evidence before the Royal Commission on the Income Tax, *House of Commons Parliamentary Papers* (1919–20) vol. xiii q.15,921, Command 288–5.

[79] Minutes of Evidence before the Select Committee on the Income and Property Tax, *House of Commons Parliamentary Papers,* (1851), vol.ix (1), q.1548, Command 354.

[80] Though such considerations were mentioned in the nineteenth century, as in Minutes of Evidence before the Select Committee on the Income and Property Act, *House of Commons Parliamentary Papers,* (1851), vol.ix (1), qq.1556, 1557, Command 354, they became particularly important in the twentieth century. See for example, and generally, Minutes of Evidence before the Select Committee on Administrative Tribunals and Enquiries, *House of Commons Parliamentary Papers* (1957) q.213, p.194 para. 14, p.678 para.11(e), q.1164. Command 218.

law in general, it was recognised that an appeal on a point of law to the regular courts would ensure the law remained correct and consistently applied, which in turn gave the legal system strength and stability, and gave confidence to the litigating public. Against this background the income tax tribunals appeared anomalous with respect to appeal provisions. The general consensus remained that there should be no appeal on facts, for to do so would be both impracticable and unnecessary, but the demand for an appeal on law could no longer reasonably be resisted.

An Act of 1874[81] gave the Crown and the taxpayer the right to require both the General Commissioners and the Special Commissioners to appeal by way of case stated to the High Court, on the grounds that their decision had been erroneous in point of law.[82] The procedure differed slightly from that in operation in the assessed taxes,[83] in that legal argument was allowed, and reasons for the ultimate decision expected. Though the Board of Inland Revenue, in its Annual Report of 1874, described the change in the law as 'new and important,'[84] there was very little public discussion of the development.

The provision for an appeal on a point of law from the income tax tribunals to the superior courts confirmed the former as subordinate adjudicatory bodies whose decisions were subject to an overriding power of amendment and, therefore, restraint. Its further significance, however, was somewhat limited. The power was essentially technical, to redress mistakes of law and thereby to ensure consistency and correctness of the administration of the law in the interests of both the law itself and the protection of the subject. It accorded a formal or conventional place in the judicial hierarchy, rather than a substantial one. More revealing of a real integration of income tax tribunals into the legal system is the extent to which they were subject to the supervisory powers of the superior courts of law. Unlike appeal, judicial review was a creature of the common law.

The extension of judicial review to statutory tribunals, including the income tax tribunals, is principally part of their post-Victorian history, though the period saw the laying of the necessary foundations, and the process of development occupied most of the nineteenth century. The King's Bench possessed an ancient jurisdiction to supervise the activities of inferior courts, of bodies strictly and unambiguously part of the pattern of the

[81] Customs and Inland Revenue Act 1874, (37 Vict. c.16). The procedure was founded on the Queen's Remembrancer's Act 1859, (22 & 23 Vict. c.21) s.10.
[82] See generally C.Stebbings, 'The Appeal by way of Case Stated from the Determinations of General Commissioners of Income Tax: An Historical Perspective,' [1996] *British Tax Review* 611. Note that there was a precedent for the use of the case stated procedure within the internal income tax structure itself: *ibid* p.617.
[83] For examples of assessed taxes cases, see *House of Commons Parliamentary Papers* (1831–2) vol. xliv 1ff.
[84] 17th Report of her Majesty's Inland Revenue on the Inland Revenue for the Year Ended 31 March 1874, *House of Commons Parliamentary Papers* (1874) vol. xv 673.

recognised legal system, to ensure that they conducted themselves as bodies which formed part of that system should. The jurisdiction ensured that inferior courts kept within their jurisdiction, kept proper records, and observed the rules of natural justice.[85] The jurisdiction was, as such, an affirmation of the essential qualities required of an adjudicatory body which claimed a place in the legal system of the country.

The principal method whereby the decisions of the common law courts were reviewed was the writ of error. Through this the court of King's Bench required the record of proceedings in the court in question to be sent to it for review for an error of law.[86] Tribunals such as the income tax tribunals were excluded from this form of review, since they were not courts of record of the common law, and the operation of the remedy depended on the existence of a record. Even the analogous writ of false judgement, which inferior courts not of record could employ instead of the writ of error, was not available to them, since they were not courts of the common law.[87] The income tax tribunals, like all tribunals, constituted new jurisdictions established by Act of Parliament to administer specialist rules in a limited sphere laid down in the parent Act, and to do so by methods very different from those of the common law courts. The common law courts employed writs, pleadings and jury trial; their proceedings were in Latin, their judgements were formal and their judges experts in the law. Tribunals, on the other hand, enjoyed a large degree of informality, proceeded in English, eschewed written pleadings and jury trial, and were staffed by men ignorant of the rules of law.

Certiorari, an ancient writ whereby the court of King's Bench used its inherent power to restrain courts of inferior jurisdiction from exceeding their powers,[88] was a possible alternative to error.[89] However, the original three fundamental requirements for the application of the writ made it appear impossible that it should apply to the income tax tribunals and similar bodies.[90] These preconditions, which were interrelated, were that the tribunal should be a court of record, that it should be a court proceeding according to the common law, and that it should, indeed, be a court. The first requirement was overcome by requiring the existence of a record rather than status as a court of record. The second was overcome by arguing that

[85] R.M Jackson, *The Machinery of Justice in England,* (7th edn, Cambridge, 1977) pp.167–68.
[86] Errors in the determination of fact could not be reversed by the writ.
[87] *Groenvelt v Burwell* (1697) 1 Ld Raym. 454 at 469.
[88] See generally Jaffe and Henderson, 'Judicial Review and the Rule of Law: Historical Origins,' 72 *Law Quarterly Review* 345 (1956); S.A. de Smith, 'The Prerogative Writs' 11 *Cambridge Law Journal* 40 (1951); Edith G. Henderson, *Foundations of English Administrative Law* (Harvard University Press, 1963).
[89] *Groenvelt v Burwell* (1700) 12 Mod. 386 at 389, and see counsel's argument in *R. v Coles* (1845) 8 QB 75 at 79.
[90] See generally C. Stebbings, 'The Origins of the Application of *Certiorari* to the General Commissioners of Income Tax,' [1997] *British Tax Review* 119 at 123–126.

although the new statutory tribunals did not follow common law procedures, they did follow the substantive common law in that they administered the law of England, albeit statutory law, and were bound by the fundamental rules of the common law as to evidence, natural justice and judicial precedent. For the purposes of *certiorari*, a tribunal administering substantive law known to the common law and according to its fundamental tenets was acceptable in principle, because the common law courts were competent to review the decisions of such tribunals. So when the income tax tribunals adopted adjudicatory as well as assessing functions, in principle the first two requirements for the application of *certiorari* had been overcome. The last requirement, however, was to prove more intractable, and revealing as to the place occupied by the income tax tribunals in the pattern of the Victorian legal system.

It was not immediately clear that the income tax tribunals constituted a court in the strict sense of the term. In some ways they were evidently not: they were not presided over by a legally qualified person, their procedures were not fixed, and their hearings were held *in camera*. On the other hand, they did possess some of the usual *indicia* of a court of law. They had the power to resolve disputes, to administer oaths and to award penalties, and an obligation to observe the rules of natural justice. Furthermore, their determinations undoubtedly affected the rights of individuals. On balance, however, their functions, procedures and constitutions were not those of traditional courts of law. This was the case with most statutory tribunals in the Victorian period. One example of many is the decision in 1891 that an assessment committee, a tribunal given the statutory duty to hear and determine objections to valuation lists for the purposes of rating, was not 'a court or a tribunal exercising judicial functions in the legal acceptation of those terms'[91] because they had no power to summon witnesses, compel production of documents or administer oaths.[92] The income tax tribunals were perceived as administrative bodies. Their hearings were private, they had close relations with a department of the Executive, and they were appointed under Acts for the management and regulation of taxes in order to execute the substantive income tax legislation. Their primary function was to take responsibility for the assessments to income tax, an undoubtedly administrative function. For most of the Victorian period this function prevailed over their judicial function of hearing and determining appeals against assessments. There was a widespread and persistent view that their adjudicatory function was nothing more than the final step in the administrative

[91] *R. v Assessment Committee of St Mary Abbotts, Kensington* [1891] 1 QB 378, *per* Lord Esher MR at 382.

[92] See too *Royal Aquarium and Summer and Winter Garden Society Ltd v Parkinson* [1892] 1 QB 431; *Copartnership Farms v Harvey-Smith* [1918] 2 KB 405. Licensing justices were similarly held not to be a court giving judgment in litigation in the traditional sense in *Boulter v Kent Justices* [1897] AC 556 at 569; *Sharp v Wakefield* [1891] AC 173.

procedure of assessment to tax, and indeed there was no clear distinction between them. It followed that there was no *lis* in any appeal before them, for they were mere valuers, and in this respect they were regarded as identical to licensing justices.[93]

The courts could have taken the view that this lack of status as a traditional court, this lack of 'place,' illustrated predominantly by the administrative rather than the judicial function, was fatal to the application of *certiorari* to the income tax tribunals, because it was long settled that the writ did not lie in relation to acts which were purely ministerial in nature.[94] The courts, however, did not adopt this strict approach. They were able to find that full status as a court of law was unnecessary for *certiorari* to apply.[95] They turned instead to the interpretation of the term 'judicial act.' The term could refer to the discharge of the duties of a judge in court, or alternatively to administrative duties which had to be discharged with a 'judicial mind,' namely 'a mind to determine what is fair and just in respect of the matters under consideration.'[96] If a tribunal had the duty to hear and determine issues which affected the rights of subjects, and had to act judicially in the sense of conducting its proceedings with fairness, impartiality and in good faith, then there was sufficient analogy with a court to allow the application of the writ. The income tax commissioners satisfied this requirement. The governing Act of the General Commissioners laid down that their duty was to hear and determine all appeals made in pursuance of the Tax Act,[97] and also provided that each General Commissioner should take an oath whereby he swore that he would '…judge and determine upon all Matters and Things which shall be brought before [him] under the said Act, without Favour, Affection or Malice…'[98] Implicit in these requirements was a duty to act fairly, impartially, and in good faith, in other words, to act judicially.[99]

By so cloaking administrative functions in judicial form, the courts brought a number of quasi-judicial tribunals into the scope of *certiorari*. By the end of the nineteenth century the principle of control of statutory tribunals by the superior courts was firmly established, and it applied to each new tribunal as it was created. This judicial creativity is revealing as to the place of the income tax tribunals. On the one hand it affirmed their place

[93] *IRC v Sneath* (1932) 17 TC 149 at 163–4; see generally C. Stebbings [1992] *British Tax Review* 398 and [1993] *British Tax Review* 52.
[94] See for example *Re Lediard* (1751) Sayer 6; *R v Edward Pryse Lloyd* (1783) Cald. 309; *Re Constables of Hipperholme* (1847) 5 Dowl. & L. 79.
[95] Because the older cases did not specifically address the issue of *certiorari*. See *R. v Assessment Committee of St Mary Abbotts, Kensington* [1891] 1 QB 378.
[96] *Per* Lopes LJ in *Royal Aquarium and Summer and Winter Garden Society Ltd v Parkinson* [1892] 1 QB 431 at 452.
[97] 43 Geo.III c.122 s.144.
[98] 43 Geo. III c.122 Schedule F.
[99] The first reported instance of the application of *certiorari* to the General Commissioners was *R. v Commissioners of Income Tax for the City of London* (1904) 91 LT 94.

within administrative tribunals in general and afforded them a place within the formal legal system as a body which was sufficiently judicial in nature to require control by the regular courts. The latter did not want such bodies to remain outside the sphere of their control. The fact that this could only be done through extensive adaptation of the rules of the common law suggests that statutory tribunals were not by their essential nature a part of the regular legal system. The outcome was the judicialisation of administrative tribunals, the strengthening of their place in the legal system.[100] It imposed and ensured a certain comparable standard of conduct of proceedings, and thereby acknowledged a similarity of function. The regular courts were claiming tribunals as their own.

The lay character of the income tax tribunals placed them immediately, if loosely, within the cultural context of the foundations of the formal legal system in that pragmatic and amorphous mass of dispute resolution bodies of limited jurisdiction in which the boundaries of central justice, administration, and private settlement were both varied and unclear. Their common features were too generalised to permit meaningful classification: lay adjudicators who possessed administrative functions too and jurisdictions restricted by the size of the claim or the nature of the subject-matter. So limited were their powers and so inclusive their personnel that they inevitably were perceived as inferior to the regular courts of law, with their broad jurisdictions and exclusive judges. Such was the variety and breadth of this dispute resolution culture that the income tax tribunals could claim to be a part of it. Nevertheless, the popular perception of the income tax tribunals was that they stood on the periphery of the bodies within the class, while other constituents, such as the Justices of the Peace and juries, were perceived by both the law and the public unequivocally as elements of the formal legal system. Since the majority of General Commissioners of Income Tax were also Justices of the Peace, the reason did not lie solely in the personnel, and neither did it lie in the administrative nature of some of their duties, for Justices possessed those too. It lay, more particularly, in the nature of the jurisdiction. In their creation solely to administer the income tax legislation they were so highly specialised that they were not perceived as a tribunal enforcing the judicial power of the state to protect the rights of the subjects, but as instruments of the Executive to promote government policy. They were the first of a number of such bodies created to implement recent, statutory and generally contentious law, and that alone set them apart from other lay dispute resolution bodies.

Their place among these new statutory bodies was equally problematic because there was no system of tribunals as such. The principal feature of the statutory tribunals of the nineteenth century, and indeed of today, is

[100] R.M. Jackson, *The Machinery of Justice in England,* (7th edn, Cambridge 1977) pp.174–177; C. Harlow and R. Rawlings, *Law and Administration,* (London, 1997) Chapters 12, 14.

that their growth was entirely *ad hoc*. No single model of alternative dispute resolution was adopted by the Legislature where it was needed in interventionist social legislation. At most there was some subject-specificity: models were used in cognate subject areas. So one model was employed for tithe commutation, copyhold enfranchisement and the inclosure of common land, and yet another in the land tax, assessed taxes and the income tax. These tribunals, including the income tax tribunals, were subject-driven.

The Victorian period produced the 'bespoke tribunal.' Its features were dictated by the subject matter the tribunal was formed to address and accordingly each was inevitably *sui generis*. The income tax tribunals had characteristics which set them apart from other tribunals, such as their private hearings, but which suited their particular requirements. Despite the movement for the rationalisation of the legal system culminating in the Judicature Acts of 1873 and 1875,[101] the perception of the legal system was individualistic and empirical. It was thought that the country should provide courts adapted to try all classes of cases in the way most suitable to the nature of the questions presented to it. This was maintained as an ideal within the formal legal system itself, but it does go some way towards explaining why the subject-led, *ad hoc*, development of tribunals occurred.[102]

The influence of the income tax tribunals in this context, however, is surprisingly limited. Their parent department of the Executive was one of the earliest, most highly developed and most active. It would have been natural for its organs to be looked at as models for similar emerging institutions, but in this period of immense growth and development of new dispute resolution bodies, the institution which could be regarded as the prototype, the commissioners of the land tax and the income tax, was rarely if ever mentioned as an appropriate or useful model. In the creation of tribunals in the field of tithe commutation, copyhold enfranchisement, inclosure, and in railways, the references to the tax tribunals in the thousands of pages of minute inquiry in Select Committees and Royal Commissions come to single figures. They were regarded as totally self-contained, and as such had no wider impact. The range of tribunals was so great, with some being almost indistinguishable from the regular courts, and others much closer to the administration of the state, made it equally difficult for them to find a place, even as a class, within the formal legal system, particularly the highly structured edifice constructed by the Judicature Act of 1873. Neither could each seek a place on an individual level. The characteristics of the income tax tribunals, for example, set them apart from the regular courts on a functional, structural and procedural level.

[101] 36 & 37 Vict. c.66 and 38 & 39 Vict. c.77.

[102] First Report of the Judicature Commissioners, *House of Commons Parliamentary Papers* (1868–9) vol. xxv p.1, Command 4130.

And yet, despite this highly individualistic approach – or perhaps because of it – there was a popular and an official demand for a formal relationship with the regular legal system. The public wanted the reassurance of a recognised connection with the judicial system, while the Legislature wanted control. In the absence of place, in the sense of status, came a relationship with the courts based on power. The great variety of procedures and personnel gave rise to a need for the formal supervision of the courts to ensure an acceptable quality of judicial activity. This adherence to fundamental values of judicial behaviour was achieved through providing for appeal on points of law, and through the application of the prerogative writ of *certiorari*. The presence of such control could paradoxically have the effect of giving the income tax tribunals a place in the formal legal system, but equally of confirming that they had no such place. The provision for appeal and judicial review by the regular courts affirmed the status of the tribunals as decision-making bodies which affected the rights of individuals, and which were, as such, the responsibility of the formal legal system to ensure that taxpayers were protected against bad justice. They stood alongside that system, part of a wider, less structured and less coherent judicial environment whose lack of procedural and substantial uniformity was tolerated[103] in the Victorian period in a way it would not be in the following century.

[103] Lack of uniformity of this kind was not tolerated in the formal Victorian legal system: see the Second Report of the Judicature Commissioners, *House of Commons Parliamentary Papers* (1872) vol.xx p.217, Command 631.

4

Aspects of Schedule A

JOHN TILEY

ABSTRACT

BENEFITS ARISING FROM land were originally charged to UK income tax under Schedule A. The basis of the charge under Schedule A was however very different from what prevails today and rested on a concept of annual value which in some, but not all cases, was rooted in a notional letting value. This chapter looks at the scope of the original Schedule A introduced in 1803 and which survived until 1963. It argues that it is wrong to treat the Schedule simply as part of an income tax when other evidence suggests that the 1803 Act was actually a combined tax on income and property. The chapter goes on to raise some technical questions before ending some current policy issues, suggesting that there is much to be said for the old Schedule A charge.

1. Introduction

There are three reasons for thinking about Schedule A in its pre-1963 form. It provides a useful exercise in trying to work out how our ancestors viewed their tax law (on which see part 2); it raises some interesting technical questions (on which see part 3) and it is important for tax policy (on which see part 4). This is however very much work in progress. A complete study of Schedule A and Schedule B remains to be written - in due course.

If one looks at a book on Income Tax published in the 1950s, such as Konstam's Income Tax, 12th edn 1952, with the 1958 supplement soon to be the basis of Wheatcroft's celebrated Income Tax, one will find a chapter on Income Tax under Schedule A. If one looks at the theoretical literature of the time one would find this taken as an example of imputed income, a species of income arising outside the ordinary processes of the market.[1] The emphasis is all on income; yet, as the argument set out in part 2 tries

[1] Marsh (1943) 58 *Political Science Quarterly* 514.

to make out, this approach seems to be wrong or, at least, unhistorical and so potentially misleading.

Schedule A was part of the original schedular tax system introduced in 1803,[2] which, as Dr Avery Jones shows in his chapter above, meant that, thanks to the effectiveness of the system of deduction at source, there was no need for the taxpayer to make a general statement of income (the main objective of these changes being to counter evasion).[3] Schedule A remained part of the UK tax system until 1963 and so its last full legislative enactment is to be found in the Income Tax Act of 1952. After 1803 it reappeared with some changes in 1805 and more changes in 1806 when it was streamlined by having the relief for repairs removed;[4] it reappeared in this form in 1842.[5] There were few changes until the end of the nineteenth century and the start of the twentieth. It duly appears in the consolidations of 1918[6] and 1952.[7] It was accepted as sound doctrine by the Royal Commission of 1920, which nonetheless recommended some changes eventually made by FA 1926, and by the Royal Commission of 1955. It was repealed by FA 1963.[8]

The Schedule A currently in force in the UK began life as Schedule D Case VIII[9] by that same FA 1963 and was restored as Schedule A in the 1970 consolidation. This taxes profits from the ownership of land – actual profits not notional profits and so not imputed income. By contrast, the original Schedule A did tax imputed income – as one now puts it. More correctly, it charged tax on the annual value of land in the United Kingdom; the current concept of annual value is to be found in TA 1988 s. 837.

[2] 43 Geo III chapter 122, substantially reenacted as 45 Geo 3 c. 49 (1805) and 46 Geo 3 c. 65 (1806). For other detailed references see Avery Jones above . On the genesis of the legislation from 1799 to 1806 see A. Farnsworth Addington: Author of the Modern Income Tax Stevens London, 1951 and Piroska Soos: The Origins of Taxation at Source International Bureau of Fiscal Documentation, 1998 These two works contain references to much contemporary material especially the Exposition of the 1803 Act and 'A Guide to the Property Act 1806' both published by Joyce Gold, Shoe Lane. It appears that no copy of the latter (1806) book exists in the United Kingdom; however, there is a copy in the library of Congress Washington DC 1806 and I am very grateful to Dave Hartnett, Head of Revenue Policy and Deputy Chairman, Board of Inland Revenue for enabling me to see a copy of this work.

[3] For a comparison of Pitt's scheme of 1799 and Addington's of 1803 see Farnsworth op cit chapter 3.

[4] 45 Geo 3 c. 49 (1805) and 46 Geo 3 c. 65 (1806). The earlier allowance for repairs of property was a general one and limited to a fraction of the annual value. The deduction for children was discontinued at the same time. £60 exemption reduced to £50 and restricted to earned income (or income from professions trades and offices); for arguments over the restriction see Farnsworth op cit.

[5] 5 and 6 Vict c. 35 opening paragraphs; the detailed rules are in ss. 60–88

[6] ITA 1918, First Schedule.

[7] ITA 1952 ss. 82 et seq.

[8] FA 1963, ss. 14; consequent changes and the introduction of Schedule D, Case VIII were effected by ss. 15–32.

[9] Schedule D Case VII was the short term capital gains tax introduced by FA 1962 ss. 10 et seq.

If land was let at a rack-rent the rental figure was the annual value. If it was not let at a rack-rent the legislation took the rack-rent at which the land was worth to be let by the year.[10] The term rack-rent was not defined in the legislation.[11] Any rack-rent within the previous seven years could be used.[12]

However this is only part of the story. Our original Schedule A had three subdivisions called rules (with numbers) rather than Cases.[13] Rule I, which has just been outlined, was the general rule and applied to all lands tenements, hereditaments or heritage capable of actual occupation. Rules II and III were different and used profits rather than rack-rental value as the measure of liability, although they then expressed that measure of liability consistently with Rule I, as the 'annual value'. Rule II applied to cases where the basis was profits rather than annual value and applied to tithes, manors and other royalties, fines received in consideration of any demise and other annual profits arising from lands etc. not being in the actual possession or occupation of the person to be taxed. So, at the risk of repetition, the annual value was determined by reference to the profits, not rack rental value, and was applied sometimes to the average of a number of years. Rule III applied to certain types of mines and again used profits rather than rack rental value – and used an average, here of five years – to give the 'annual value' and so the amount to be taxed. The rest of this paper will concentrate on Rule No I but just occasionally the other rules will reappear.

One might be tempted to see the old Schedule A (Rule No I) as an example of presumptive taxation, defined by Thuronyi as involving the use of indirect means to ascertain tax liability.[14] But if Schedule A is an example of presumptive tax, what is the tax liability for which the annual value is taken as the indirect measure? Schedule A could perhaps have taxed the profits arising from the ownership of land but it did not. Nor did it even try to tax the annual value arising from the occupation of such land. Profits arising from occupation were left to Schedule B, a phrase which sounds familiar since the current Schedule A, para. 2 specifically excludes profits arising from the occupation of land. It is therefore best not to see Schedule A as an example of presumptive taxation at all but to try and take it in own terms as a tax on land.

It is important when looking at the original Schedule A to remember the link with local taxation. As just seen, the annual value for Schedule A was geared to the rackrental value of the land – whether there was a lease or not.

[10] ITA 1952 s. 82 Schedule 2.
[11] In *Steven v Bishop* 2 TC at 255 Lopes LJ defined it as the full annual value of the tenement or as near a possible (actually concerned with cost of collecting a tithe rentcharge were deductible and held that they were) probably the point is that in calculating the rent it is the landlord's job to keep the place in good repair.
[12] 5 and 6 Vict Schedule A General Rule No 1, ITA 1918 First Schedule, Schedule A General Rule 1 no 1; ITA 1952 s. 82.
[13] This tripartite division dates from the 1805 Act.
[14] In Tax Law Design and Drafting IMF 1996 chapter 12 at p. 401.

This base was already in uses for local taxation in 1803 and remained so until the replacement of local authority rates by the famous community charge (commonly but incorrectly known as the poll tax) in 1988 which was in turn replaced by the council tax.[15] The 1803 legislation specifically links the annual value for Schedule A to that used for local taxation.[16] In the *Coltness* case, which actually concerned Schedule A Rule No III, this link with local taxation was used as one reason for refusing the taxpayer's claim to a deduction for depreciation.[17]

So to recapitulate. The annual rental value used for the old Schedule A Rule I differs from what is now taxed under the current (post 1963) Schedule A in two principal ways, First, its relationship to any actual rent depended on the reliability (i.e. accuracy and contemporaneity) of the valuation and the reaction of the Revenue if receipts fell below the annual value. If the valuation process failed to keep up with current values, as happened in a particularly serious way after 1936, one could get a situation in which the annual value fell far below not just the value for which the property could have been left but also the amounts for which the property was actually let. This 'excess rents' problem gave rise to the leading schedular system case of *Fry v Salisbury House Estates Ltd*,[18] in which the House of Lords refused to allow the Revenue to tax these receipts either under Schedule A or Schedule D Cases I or VI. Secondly, Schedule A taxed the owner-occupier who received no rent at all. So a person owning and occupying land had to pay tax on the annual value – this profit arose from ownership and therefore came under Schedule A. If it was a home, tax was paid under Schedule A and that was that. If the land was used for a trade or profession, tax was due under Schedule A on the land in addition to tax under Schedule D on any business profits – the Schedule A value was taxed under Schedule A and so did not form part of the Schedule D income. If there was a net loss under Schedule A, as computed under Schedule A rules, the excess could not be used against D profits.[19] An owner occupier who was also a farmer was originally taxed under Schedule B rather than, as now, under Schedule D on the farming profits but was still liable to pay tax under Schedule A as well.

[15] On proposals for reforming the old rates system see Report of the Committee of Enquiry into Local Government Finance (1976) Cmnd 6455 (generally known as the Layfield report); the community charge and its background generated a substantial amount of literature see e.g. Butler Adonis and Travers Failure in British Government; the Politics of the Poll Tax OUP 1994; the Layfield report is discussed at op cit pp. 22–25.

[16] E.g. 43 Geo 3c, 127 ss. 60–63; later versions are in 46 Geo 3c. 65 s. 76, and 5 and 6 Vict c. 35 s. 64. TA 1988 s. 837 links annual value in one respect to the General Rate Act 1967 s. 23; unfortunately the 1967 Act was repealed by the Local Government Finance Act 1988 s. 177.

[17] (1881) 1 TC 287 at 317 per Lord Blackburn.

[18] [1930] AC 432, 15 TC 266.

[19] ITA 1952 s. 136, formerly Schedule D Cases I and II Rule 5; against such a background some of the apparently curious rules in TA 1988 s. 74 make more sense.

The burden of the charge under Schedule A fell on the person in occupation – whether or not the owner. If L, a landlord, owns land and leases it to T, the tenant, it was generally T who was liable to tax under Schedule A in the first place[20] and this was collected by direct assessment on T. However, to anticipate a point made later on, T, on paying the rent to L, was allowed to deduct the amount of tax he has paid under Schedule A from the rent paid to L. In this way the burden is shifted from T to L.

2. Was Schedule A a Tax on Income?

It is all too easy to approach old legislation with the assumptions of today. So today's assumptions make one talk in terms of income tax and imputed income as seen in the 1950s textbook already cited. Yet those who drafted the legislation in 1803, 1806 and probably 1842 did not accept these assumptions. First, they would not refer to the legislation as the Income Tax Act; that did not come about until 1892 when the 1842 'Act for granting to her Majesty Duties on Profits arising from Property, Professions, Trades and Offices, until 6th day of April 1845' was given the title of The Income Tax Act 1842.[21] Since the original title was such a mouthful an abbreviation was often used but when this was done in the speeches in the House of Lords in *Coltness Iron Co v Black* we find the members of the House of Lords referring to a tax on 'property and income' or 'income and property'.[22] There was no reference in 1892 to the 1803 Act since that was no longer in force but that had been entitled 'An Act for granting to his Majesty, until 6th Day of May next after the Ratification of a Definitive Treaty of Peace, a Contribution on the Profits arising from Property, Professions, Trades and Offices.' The curious will take note both of the word 'contribution' rather than 'duty' and the date of 6 May not 6 April.

So it may be that Schedule A was seen not as a part of an income tax but as part of a system of income and property tax. For this there is further evidence of the most direct sort in the language of the time. So the Inland Revenue in their 28th Report refer to 'The Property and Income Tax or as it is popularly called the Income Tax'.[23] When one looks closely at the tables in the annual reports starting in 1857 one also sees it described as Property and Income Tax. Likewise the 1851 and 1852 Select Committees

[20] The list of situations in ITA 1952 s. 175 in which the lessor is liable applies to the excess rents charged under D Case VI and not the general Schedule A liability.
[21] Short Titles Act, 1892.
[22] (1882) I TC 287 *per* Lord President (307) Penzance (313) and Blackburn (317).
[23] At p. 73.

were called Committees on the Income and Property Tax. And the clinching argument is a Book published in 1806 is called a 'Guide to the Execution of the Property Act' and begins with a reference to tax on property and profits.[24] So Schedule A was probably seen originally not as a tax on income but as part of a tax on property and income or more simply, in this part of the Act, on property with the result that there was no need at that time for the mental gymnastics we associate with imputed income.

Nor should one really be much surprised. As has been shown by Farnsworth and, more recently, by Piroska Soos,[25] the Acts of 1799 and 1803, whose full title have just been set out, did not purport to spring fully armoured from the head of Zeus. Taxes had been charged on movable and immovable property for many many years – as can also be seen Dowell's[26] remorseless recitations. A central government tax on the annual value of land can be traced back at least to 1404.[27] As is generally known, income was used as a relief from the burden of other taxes charged on various types of property by the Triple Assessment of 1798 so the boundary between income and property as a tax relevant matter is blurred from the start. Eighteenth and nineteenth century folk may well have regarded other sources – even a profession and certainly an office – as property also; offices were still bought and sold and the notion of buying a share in a partnership is still current.

Then there is Farnsworth's account of how the 1803 Act came to be passed by Addington's administration after Pit had left the government in 1801. The new tax was originally contained in two bills one known as the Property Tax Bill and the other as the 'Personal Property and Income Tax Bill'; these were later consolidated into the single bill known as the Property and Income Tax Bill.[28]

So if one can quite comfortably say that it is wrong to think of the 1803 Act as a pure tax on income one now has to face the uncomfortable question whether it actually mattered. I agree with Daunton above[29] that we are not dealing with systematic legal thinking; the values of our tax system are administrative values – the plumber not Pericles. I think it likely that in the nineteenth century people did not think about the concept of income beyond the schedules. As Wueller wrote.[30]

[24] See above n. 2.
[25] Above note 1.
[26] Dowell S *History of Taxation and Taxes in England* 3rd edn 4 vols 1965 Frank Cass, London; vols 5 and 6 dealing with the years 1885 to 1965 were written by Ilersic and a much more enjoyable read.
[27] Rot Parl III, p. 522 cited by Jurkowski, Smith and Crook Lay Taxes in England and Wales 1188–1688, Public Record Handbook No 31.
[28] Op cit pp. 56–58.
[29] Above chapter 1, pp. 4 and 10.
[30] (1938) 53 *Political Science Quarterly* 83 at 85.

'The British, though they look upon a century and a half of income tax experience, apparently have never undertaken – in a continuous and systematic way – to develop a general concept of income. No evidence has been discovered which would lead one to suspect that the Inland Revenue definition of income has ever been seriously questioned. Alfred Marshall accepted it. Pigou did not quarrel with it. Even the Royal Commission on Income Tax (1920) did not attempt a general definition of income. By way of introductory remark the Commission observed p. 4 the plan adopted has been not to attempt a general covering definition of income but to define income as it falls under each of the divisions'[i.e. Schedules].

It is not immediately clear why the British have not thought much about the concept of income. Is it just because of the schedular structure we have inherited? Of course this is understandable if it was not a coherent income tax but a rag bag of taxes on property and profits. However another and somewhat riskier explanation is to be found in national character. If one substitutes the Englishman for the British, one can find an explanation in Tony Weir's comment in 1975,[31] when explaining why the distinction between public and private law was so much less important in England than in continental Europe. 'The Englishman,' he wrote, 'is naturally pragmatic, more concerned with results than method, function that shape, effectiveness than style. He has little talent for producing intellectual order and little interest in the finer points of taxonomy.'

Finally one might, a little seditiously, ask whether Addington got it right and that the UK ought to take as its principal personal tax based on ability to pay not income tax, as is currently claimed, but rather an income and property tax. Income especially monetary income has an irresistible air of precision – and so justice – about it. Yet, as is clear from the treatment of financial instruments and loan relationships, returns from assets can come in many and often easily interchangeable forms. If the tax system makes some taxable in one way and others in others then tax arbitrage will ensue. As a result much work has been done in recent years, especially in the corporation tax area, to reduce the arbitrage opportunities but all this has been done without having had to get to grips with concept of income itself, such as they have elsewhere in the world.[32] It may be that the UK in its pragmatic way is right to resist such analysis and to rely on some deep instinctual feel generated by the law of trusts and by modern accounting practice but while this tells us much about the distinction between capital and income, it does not help us resolve the consequences of that distinction. One solution, found in some other systems, it to have an 'income' tax which

[31] Encyclopaedia of Comparative Law volume 2 para 82.
[32] See e.g. Ault ed Comparative Income Taxation Kluwer 1997 and classic articles by Wueller (1938) 53 *Political Science Quarterly* 83 and 557 and (1939) 54 *Political Science Quarterly* 555.

uses a deemed rate of return from a set capital value.[33] Does one call this an 'income' tax or a 'property' tax? Of course, we must not call this a 'wealth' tax since we have known since 1975 that this is unworkable.[34]

Nor were the Victorians blind to all this, as one can see in some of their proposals to reshape the existing tax in the cause of differentiation – even though there proved to be a large gap between proposal and acceptance. Thus, Hubbard's draft report from 1862 suggested that one could get the right balance between taxing income from property as differentiated from income from labour by capitalising property and profits and charging duty on a rate of interest in relation to the nature of the capital. The tax could be adjusted according to capital value of the property or income, the tenure and the age of its owner. Members of the Meade Committee may be reminded of their own work on capital transfer taxation.[35] The idea was savaged by the 1862 Committee '[we] have arrived at the conclusion that the plan proposed by their chairman does not afford a basis for a practicable and equitable readjustment of the income tax and they feel so strongly the dangers and ill consequences to be apprehended from an attempt to unsettle the present basis of the tax without a clear perception of the mode in which it is to be reconstructed that they are not prepared to offer … any suggestion for its amendment.'[36]

An equally clear and elegantly insulting rejection had come ten years earlier by the Board of Inland Revenue commenting on the 1851 proposal put forward by Hume and others – and opposed by a Mr D'Israeli. Having said that it was perhaps not within its province to make any observations on the evidence nonetheless the Board might be permitted to observe that '[The idea] cannot be … reduced by its proposers to any intelligible detail so as to enable a judgment to be formed of the advantages or the possibility of carrying it into practical effect.'[37]

Part 3 Some Technicalities of the Old Schedule A.

Neutrality: renter and owner. It is well known that in the summer days of Schedule A the charge meant that a person who bought a house and lived in it was not at a fiscal advantage as compared with someone who rented a house and invested the sums in stocks and shares.[38] The fiscal advantage was conferred by the 1963 change; whether it is still true is another matter.

[33] E.g. the New Zealand Final Report of the Tax Review chaired by Robert McLeod, October 2001, chapter 7 and annex D. I am indebted to Mr Sean Richardson of Queen's College, Cambridge for this reference.
[34] Select Committee on a Wealth Tax, Session 1974–75, HC 696–1.
[35] *Structure and Reform of Direct Taxation*, George Allen and Unwin 1978 chapters 15 and 16.
[36] Cited 28th Annual Report C 4474 p. 75.
[37] First Report p. 33.
[38] See Tiley *Revenue Law* 4th edn, Hart Publishing, Oxford, § 1.6.2.

Neutrality: rent and premium. The treatment of premiums under the pre 1963 rules is an interesting exercise involving paying attention not just to Rule I but also to Rule II of the Schedule. In our current law these are regulated by TA 1988 ss. 34–36 which split the premium between income and capital according to the length of the lease, the shorter the lease the greater the income element. Whether this is a more or less advantageous than the earlier rule depends on what the earlier one was – which is not easy to work out.

One view, which conveniently ignores Rule II, would say that the true effect of Rule I which takes the rack-rental annual value as a good example of neutrality. Taking the annual value for Rule I rather than the rents received meant that one could tax the property the same way year by year whether it was let at current rack-rent value or at a peppercorn rent with a large premium.

In the United States a premium is sometimes regarded as income. One's instinctive (post 1963) reaction was that normally, i.e. outside the context of trading in land, the UK treated such a payment as capital. However when challenged to find a case which said so – so that one could look at the reasoning – it is all much harder. That this is the correct analysis is beyond doubt – why else is there the *John Lewis*[39] case and case law forbidding the deduction of a premium as a revenue expense for Schedule D Case I,[40] and all that CGT legislation, but this masks the pre-1963 position. This lies in the original legislation as last re-enacted in ITA 1918 and then as reformed by FA 1926.

The issue arose in partial form in *B G Utting v Hughes*[41] This case is best known as being concerned with correct treatment of ground rents, the House of Lords distinguishing *John Emery and Sons v IRC* which concerned Scottish ground annuals.[42] However premiums were also involved. The taxpaying company built and sold houses; however they retained the freehold and gave the buyer a 99 years lease in return for a premium and a ground rent. Clauson LJ held that the effect of FA 1926 s. 28 was to move the subject matter from ITA 1918 Schedule A Rule II to Schedule D Case III so that the *Fry v Salisbury Estates* no longer operated to exclude the premiums from Schedule D. Once this had been done, the Revenue had the right to select the Case and so charge under D I rather than D III.[43]

Clauson LJ did not have to rule on the law before 1926 but suggested that the taxpayer, whom he referred to as 'the subject', was right in saying that this fell exclusively within Schedule A, Rule II and so could not come within Schedule D Case I. Schedule A, Rule II referred to receiving a fine in consideration of a demise of land and said that the receipt was to be assessed and charged to tax on the amount of profits received in respect of

[39] [2002] EWCA Civ 1869, [2003] STC 117.
[40] *Green v Favourite Cinemas Ltd* (1930) 15 TC 390.
[41] [1940] AC 463, [1938] 2 KB 231 (CA) 23 TC 174. The case is also noteworthy for the paragraph of Lord Maugham's speech insisting on correct legal analysis and not substance, 23 TC at 193.
[42] [1937] AC 91, 20 TC 213.
[43] At 246–7, 188–189.

the fine in the year preceding the year of assessment. A premium was clearly a fine. He was not persuaded of a Revenue argument that for the purpose Rule II, 'fines' meant only fines payable on renewable leases, whether renewable by covenant or by custom.

This incomplete account leaves us with unsolved mysteries, such as what TA 1988 s. 34–36 were originally meant to do; as compared with the older rules were they imposing tax on the section of the premium now treated as income part or were they relieving from income tax on the part treated as capital? Good common lawyers will reconcile the remarks of Clauson LJ with the decision in the John Lewis case on the basis that Clauson LJ was dealing not with the distinction between income and capital but with that between Schedule A and Schedule D Case I.

Other taxes Apart from local authority taxation there was the land tax, now fading, and the inhabited house duty (IHD) reintroduced in 1851 to replace the window tax. IHD was first listed in the Inland Revenue Reports with the Assessed Taxes until their repeal but continued as a tax under the Inland Revenue until its abolition in 1924.[44] It was not a large revenue raiser. Lloyd George's addiction to new taxes gave rise four new taxes on land – but not for long.[45]

Valuations and revaluations Schedule A depended crucially in having up to date and accurate valuations. At first there was no statutory duty to revalue every so often. The 1920 Royal Commission complained that there had been no revaluation since 1910 (because of World War I) and recommended that there should be revaluation every five years.[46] This was enacted ten years later[47] and led to revaluations in 1930–31 and 1935–36 but war again intervened and there were no general revaluations for Schedule A after 1945. Writing in 1963 Wheatcroft suggested that the tax would not have been repealed if the valuations had been kept up to date.[48]

The yield from the tax was further eroded by claims for repairs (below) which might mean that even if the valuations had been kept up to date the yield might not have been great. The idea of the tax system crosschecking the claims for repairs against the profits of the builders doing the work has some appeal from a compliance perspective. One should remember that the post war housing market was not as we have known it over the last few years. There was a shortage of housing as a result of the war; there was

[44] FA 1924, s. 20.
[45] Increment Value Duty, Reversion Duty, Undeveloped Land duty, Mineral Rights Duty Introduce by F (1909–1910) A, 1910 ss.1–42 repealed by FA 1920 s. 57. There are good short accounts of these duties in the Annual Reports of the Inland Revenue e.g. 55th Report C 6344 pp.149-154.
[46] RC §§ 436–440.
[47] FA 1930 s. 27.
[48] [1963] BTR 223.

very strict control not only of building supplies (as one is reminded when reading *Odeon Associated Theatres Ltd v Jones*[49]) but also of rents; on the other hand, the inflation rate was, as now, very low.

Taxation of excess rents, i.e. the amounts by which actual receipts exceeded the frozen values of the last and ever more remote revaluation, began in 1940 when it was decided that the excess should be taxed but under Schedule D Case VI – not A. Over the years the tax on excess rents became a much higher proportion of total tax take. In 1961–62 net excess rents were £139.7m while the income assessed under Schedule A was £320m.[50] For 1962–63, the figures were £165m and Schedule A £345m.[51] Those who worry why the excess rent figure looks so low in 1961–62 after all those years should remember that this was an era of rent control, with no sane person investing in property for rent to the private sector.

In the nineteenth century valuation had been much better. According to the Revenue's 28th report[52] the Schedule A assessors 'have no difficulty obtaining return from occupiers of the rent or value of the land or premises occupied.' The Assessors reported to General Commissioners who accepted (or rejected) them. Apart from London and Scotland these assessors were persons independent of the Revenue who took the job on for a fee related to results – poundage; they seem also to have been independent of those doing the valuation for local authority taxation. The gross amount assessed in 1883–84 was just over £193m; the net figure after abatements etc was £173m. Abatement features more strongly in Schedule B where the gross of £65m was reduced to £33m. For comparison the sum assessed under Schedule C was £40m and under D was £291m gross and £252m net; the gross and net figures for Schedule E are £37m and £29m.

In London an Act of 1867 meant that Inland Revenue officers (surveyors) acted as assessors and did so both for local tax and for Schedule A so that the local tax value was take for Schedule A. The same efficient system prevailed in Scotland but this was because the poundage was so small that the same surveyors made the assessments under Schedules A B and E (45 Geo 3 c. 95). Ireland was different again – the taxpayer had the option of picking the lowest of four separate values – but that is another story.[53]

Throughout this period the assessors seem to have been active – without statutory compulsion. Outside London and Scotland they revalued on a regular cycle, at first three years but later five.[54] They also revalued

[49] [1973] Ch 288, 48 TC 257.
[50] 106th Report Cmnd 2283. p. 44.
[51] 107th Report Cmnd 2572 p.52; the last year of all £187.5m and £215m – for the reason for the drop in this year see Report p. 54.
[52] C 4474 at pp.76–78.
[53] RC 1920 § 441 – and for Schedule B see § 458.
[54] RC 1920 § 436.

upwards in between times if there were improvements to the property. In practice they seem also to have been willing to value downwards at any time.[55] There was thus an imbalance; in practice any downward value was recognised but any upward movement only if it resulted from an improvement. Scotland seems to have had an annual valuation system – which the 1920 Royal Commission commended but also said needed a statutory base.[56]

The Assessors calculated both for Schedule A and for Schedule B. The information power was, as we have seen, well regarded.[57] It is interesting to look at the 1880s and note the speed with which they picked up on the drop in the value of agricultural land. Houses were going up in value but land was going down. In addition relief was given from Schedule A and B where the rent due was unpaid – on account of the depression.[58] The basis for giving the relief was the express permission of the Treasury – not Parliament. It is not clear whether anyone thought Parliament should have been asked – one suspects not.

Although the annual value basis was used both for local tax and for Schedule A, this was not always achieved outside London and Scotland. In the 1870s much work was done for the Revenue's annual reports measuring the gap between the two. Usually the Schedule A valuation was higher than the local tax – and the landowners would appeal the Schedule A assessment not out of fraud but out of a desire to avoid an increase in their local tax liability.[59] The reason why the local tax valuation was lower was that the local assessment committee did not have the Revenue's power to call for returns of rent from occupiers or owners. In some parts they inspected the Schedule A valuation list and so got much closer to the right value.

Repairs. The early and middle history of reliefs for repairs is set out in RC 1920.[60] Reliefs were given in the acts of 1799, 1803 and 1805 but not in 1806 itself and no change was then made – as opposed to debated[61] – until 1894. The reasons for the 1806 change were a) landlords were claiming for repairs in fact done by tenants (i.e. fraud) and b) as a matter of differentiation in favour of hazardous incomes.

In the developed Schedule A, there were two types of reliefs. First there was a formulaic reduction in tax liability[62] to recognise the fact that

[55] RC 1920 § 438.
[56] RC 1920 § 440.
[57] ITA 1952 s. 81.
[58] 24th Report C 2967 pp.79–80.
[59] 19th Report C 1607 pp 50–52 The exercise was repeated regularly in later years - see e.g. 22nd 1876–77 p. 43 et seq. On current research see Daunton above p.10.
[60] Appendix 7 (q); the Commission's own proposals are at §§223–233.
[61] The 1851–52 Committee had much discussion. Hubbard proposed 1/12th for lands and 1/6 for houses but this was rejected because it was seen as a flat rate and so would be unjust. What is true is that it would have been given whether landlord incurred expense or not.
[62] This masks some subtle points see Konstam §40.

repairs were incurred. In 1952 the reduction was 1/8 for land without buildings or farmlands with buildings.[63] For other houses and buildings the fraction varied from ¼ to 1/6 + £20 depending on the amount assessed.[64] For comparison the value of the personal relief in 1952 was £196 at standard rate.[65]

We can trace this relief back to Harcourt's 1894 budget, which originally proposed 1/10 for land and 1/6 for houses, and ended with 1/8 and 1/6. In 1903 it was suggested that houses and land should be shifted to Schedule D and only be taxed on the net yield – (i.e. what came in in 1963). In 1903 this was dismissed as impracticable.

The second deduction was a deduction for the actual costs of actual repairs, maintenance, insurance and management (spread over 5 years). This can be traced back to 1907 discussions and eventually the great FA 1909–10 (1910) s. 69 – which allowed for a reclaim of Schedule A tax on proof of actual expenditure on repairs insurance, management and maintenance including replacement of farmhouses, cottages, fences and other works necessary to maintain the existing rent.[66] In consultation taxpayers consulted had said they wanted relief for actual expenditure rather than an extension of the formula because wanted to avoid treating good and bad landlords alike. Whereas the first relief was given property by property this was given to all properties managed as one estate – and is the origin of the one estate election recently repealed.[67]

Further reliefs were given in due course for loss by flood and tempest[68] and under the more general relief for air raid protection works.[69] Relief for land tax, drainage rates and (averaged over a 22 year period) repairing seawalls or other embankments. It is likely that the 22 year average rule was designed to assist the taxpayer; it was a form of rolling allowance but did not give rise to any back claim for tax.

Deduction at source As is known from Dr Piroska Soos' researches,[70] the system of deduction at source in the 1803 Act was not new, but this does not affect its importance in the scheme of that Act. So while owner-occupiers paid tax by a process of assessment, tenant occupiers, who were of course, not subject to Schedule A, were a vital part of the administration – they deducted the tax from the rent they paid to the owner and accounted for it to the Revenue. The tenant was the tax collector with a very direct

[63] ITA 1952 ss. 99 and 100.
[64] ITA 1952, s. 100 (1)(a)(b) with proviso and (3).
[65] ITA 1952 s. 210.
[66] This too masked much complexity Konstam §41.
[67] TA 1988 s. 26(formerly ITA 1952 s. 101) repealed by FA 1998, s. 39 as from the start of 2001–02.
[68] ITA 1952 s.102.
[69] Ibid. s. 475.
[70] Soos above note 2.

interest is seeing that the tax was indeed collected. This system did however create a number of inequities highlighted by the RC of 1920.[71]

The overlap with Schedule D and the decision of the House of Lords in Coltness Iron Co Ltd v Black.[72] The Acts taxed various businesses under Schedule A under a part known as No III (not Case III); the 1842 list included quarries, mines, iron works, gas works, railways, bridges ferries and other concerns of like nature. An Act of 1860[73] provided that concerns in No III should be assessed according to the rules prescribed by Schedule D 'so far as such rules are consistent with the said No III'. Wider language followed in 1866.[74] On the general scope of No III, it is interesting to think of these specified concerns as being property-based and it may be easier to understand after the UK's rail privatisation legislation of the mid 1990s which split the ownership of the track and stations (Railtrack Ltd) from the actual rolling stock (the operating companies). In the same way, in the nineteenth century, the railways provided the means for carrying carriages while the wagons were owned by others. Trains might consist of carriages from various ownerships. This emphasises the point that the tax may have been seen as a property tax, with income being a good measure of annual value.[75]

In *Coltness* the taxpayers based their case on the 1860 and 1866 Acts,[76] arguing first that the effect of these words was that the basis of their charge should be 'profit' as defined under Schedule D and secondly that in computing that profit they should be allowed to write off the costs of their capital invested in sinking the mineshafts. The House of Lords held against them on both points.

On the first point, the House held that, while the provisions stated that profits could be determined by reference to Schedule D rules, this did not affect the fact that the charge still arose under Schedule A; so the Schedule D rules could only apply so far as they were compatible with Schedule A. At that time the Schedule A charge on quarries used a one year average, the Schedule A charge for mines a five year average while ScheduleD simply used a three year average. On the taxpayer's argument the three year period would have to be used in all cases.

On the second point the House noted that the legislation contained no mention of a deduction for capital exhausted. If the taxpayer was right, it could use the end-of-year trading stock rule to take a loss on the stock still in the earth and set it against the profits received – profits nil, tax nil. This

[71] §§434 (c) and 435.
[72] (1881) 1 TC 287; see also Daunton above p. 10.
[73] 23 and 24 Vict c. 24 ss 5 and 7.
[74] 29 and 30 Vict c. 36 s. 8.
[75] As Lord Penzance put it, the intention of the Act was to tax property and tax to be paid on the annual value of the estate without regard to whether he got it, or how he got it or how much he paid for it (1 TC 278 at 313).
[76] The story told in RC 1920 Appix 7 (n).

could not be right, especially if one took account of the local property tax point.[77] However it is interesting to note that the House also laid stress on a quite different point, the fact that under UK tax law as it then was, a person buying an annuity was unable to deduct the costs incurred in computing the value of the annuity.[78] This shows how central to nineteenth century thinking the taxation of annuities was.

Commenting in their Annual Report for 1881–82 on the decision in *Coltness* the Revenue pronounced that the House of Lords had got it right. The 1866 legislation had been passed because mine owners asked for it to enable them to make their returns in one sum for assessment by Special Commissioners instead of by the General Commissioners.[79] Thus the reform had been to provide the taxpayers with the same secrecy and confidentiality as for Schedule D – nothing more.

One final point should perhaps be made and it concerns the list of businesses in A No III. The listing of some businesses under Schedule A and others under Schedule D was ridiculed by the RC of 1920 and the businesses were moved to Sch D shortly after their report. Thus railways and gasworks were in A but neither tramways nor electricity.[80]

Part 4 – Bring Back Schedule A?

It appears to be some time since there was a systematic official look at the taxation of housing and it is perhaps worth mentioning three current problems: a) rising prices b) rising rents and c) rising repair costs – recent newspaper reports suggested that repairs are not being carried out or not carried out well enough and that the quality of the housing stock is going down. The right to buy council houses has enabled people to buy their own homes but as anyone who has recently employed builders will know not necessarily to have enough money to maintain them; Cambridge man with his electric drill and a TV programme is not necessarily good for the housing stock.[81] The state welfare system does not appear to be interested in helping with repair costs. A systematic look should look at all these points especially the interaction with the welfare system we call social security.

Such a review might involve looking again at the old Schedule A. The absence of an old fashioned Schedule A charge is often cited as prime example of discrimination in the continuing discrepancy between the treatment of investment in housing and investment in shares. One may however question

[77] Above note 16.
[78] E.g. Lord President 1 TC 287 sat 308.
[79] 24th Report 1881 C 2967 p. 78. The point seems to have raised first in the HC on 5th March 1845.
[80] RC 1920 §433.
[81] Cambridge man with his electric drill may also strain the notion of improvement embedded in TCGA 1992 s. 38 (1)(b).

how far this is true. Traditionally, we look at three questions a) relief for interest on loans received b) taxation of income derived and c) taxation of capital gains. Trying to answer this traditional question shows how difficult life has become.

Taking shares first: a) there is no relief for interest on loans to buy shares – although there was before 1969; b) there is a tax on dividends (Schedule F) c) there is CGT to pay on a disposal. However today and for some years now, neither b) nor c) is true if the shares are held in a PEP or ISA – with the important qualification that there is no relief for capital losses either. Moreover, if the shares are not held in such a privileged intermediary, the annual exemption may enable the gains to escape tax, an exemption which can be the more valuable with the device known as 'bed and spousing' under which the shares are sold by one spouse and a similar investment is made by the other spouse so that the first spouse realises the gain or loss as required.

With housing the answers depend on whether the property is to be let or occupied. If it is for letting there is interest relief against the rent,[82] taxation of the rent under Schedule A and taxation of the gain under capital gains tax. The gain may attract tapering relief but normally as a non-business asset – unless it is furnished holiday accommodation.[83] The long-life nature of the asset means that the annual exemption will be of relatively little use here. Property cannot be held through a PEP or a ISA – nor as part of a personal pension scheme.

It has been suggested that one way of dealing with high prices is to tax capital gains, i.e. to remove the exemption. This rather half baked idea ignores the fact that much of the recent surge in demand has been due to the buy-to-rent movement – where there is no exemption. Its introduction, presumably only with prospective effect, might have a significant effect on the tax take – and a one-off bonanza for valuers – but, as we all know tax rules have monetary effects, sometimes unpredictably so. How quickly would the extra tax be built into the price asked; to what extent would it reduce the price but increase the costs of housing?[84] Other tax systems have been wary about taxing such gains. Taxing owner occupied housing on its gains would lead to lock in of a very literal sort. So the US used to have a rollover relief rule (§1034) supplemented by a once in a lifetime exemption of a fixed amount of gain (§122). It has now moved to our exemption system (new §122 since 1997).[85]

[82] TA 1988 s. 21A superseding relief as charge on income under TA 1988 s. 355 (1)(b) by FA 1995 s. 42 (1).
[83] TCGA 1992, ss. 2A and 241.
[84] On capitalisation of tax effects see Kay and King *The British Tax System* 5th edn p. 10.
[85] On US see Burke and Friel: *Understanding Federal Income Taxation* Chapter 6.

Bringing back the old Schedule A is, in theory at least, another option. An overnight reintroduction would have a dramatic effect on the price of houses, giving rise to further negative equity problems for those who have bought recently and abolishing those retirement nest-eggs older purchasers are expecting. This is not compatible with a government wish to encourage people to be self reliant in retirement. Moreover while it would reduce the price of housing, it would not reduce the actual costs of buying – what had previously been paid to the bank as interest might well be paid to the government in tax. In principle it is to be preferred it to a major change in stamp duty rates even though high rates are the norm in several continental European countries. This is because the stamp duty only arises when there is a transaction and transactions may be the result of chance or mischance. A periodic charge like the Schedule A income tax avoids these issues.

One can come to like the idea of the old Schedule A and to admire its thinking and its balance. One can like the idea of getting rid of those rules about lease premiums as well as the idea of equity between owner and renter. At a more adventurous level one can like its defiance of the idea that income is everything. However its reintroduction is a political non-starter and one know that given the chance everyone would vote against it out of that acute self-interest which grips us all.

Part 2

Twentieth Century Problems

5

Excess Profits Duty

PHILIP RIDD

ABSTRACT

WAR GENERATES ADDITIONAL spending, which has to be funded by the Exchequer. It is well known that the Napoleonic Wars were responsible for the invention of Income Tax in 1799. Other major wars have also spawned new taxes. In the First World War Excess Profits Duty was created and it produced a quarter of the total wartime tax revenue. Wartime conditions also have their effects on the workload of the Courts of Justice.

The purpose of this paper is to present an epitome of the case law to which Excess Profits Duty gave rise. In the period 1915–1921, to which Excess Profits Duty related, there were various books and other publications concerning the tax, and the early case law received some coverage. Relatively little was published after the repeal of the tax in 1921, but the case law continued to accumulate until 1935. This paper may well represent a first attempt to gather up all that case law and see how Excess Profits Duty fared in the Courts. The aim of the paper is to give a flavour, rather than an exhaustive analysis, of the cases, with a view to stimulating interest in the topic on its own account, and to demonstrating that the case law has a lingering relevance, particularly for Income Tax.

INTRODUCTION

'I desire to observe at the outset that we are dealing with what is known as and what was imposed as the Excess Profits Duty, its name indicating that it was a duty upon excess profits; it was designed, as we all know, to try to secure to the Revenue a portion of the profits being made in the course of the War which were said to be enhanced by the circumstances of the War and, being so enhanced, to be beyond the sum which the subject was entitled to keep free of taxation, inasmuch as he ought not to be entitled to make a larger profit due to the misfortune of the nation at large in being at war'.

Those words, which appeared in the judgment of Lord Hanworth MR in *Birt, Potter & Hughes Ltd v CIR* (1927) 12 TC 976, at page 990, are a neat description of the nature of Excess Profits Duty and of the reasons for its creation. Lord Hanworth had good reason to remember the Great War, as his only son was one of those killed in action.

In his book 'A History of Income Tax', the late Basil Sabine dealt with taxation during the First World War in a chapter entitled 'Trial by Battle - I' (pages 140–156). He wrote of two distinct periods. In the first, Lloyd George, the Chancellor of the Exchequer, concentrated on increases in income tax, supertax, and indirect taxation, but he was preoccupied with the making of weapons and in May 1915 he transferred to the Ministry of Munitions. He was succeeded as Chancellor by the banker, Reginald McKenna, and greater attention was then paid, starting in the September 1915 Budget, to putting taxation on a war footing. Many taxes were increased, and Excess Profits Duty was introduced. Basil Sabine described this as follows:

'By now the word "profiteer" was current and the taxing of excess profits became a moral as well as a fiscal necessity. McKenna therefore imposed an Excess Profits Duty which was retained until 1921 and which accounted for no less than 25 per cent of the total tax revenue during the period. Critics have regarded it as not as effective as it might have been; it could have been imposed earlier; it was subject to evasion, as indeed is any tax with a high rate which always stimulates avoidance; there was a marked time lag in collection; EPD was still coming in fifteen years after its repeal; and an overworked staff found it difficult to administer. It is said that when the draft Bill came out, Sir John Simon, who had just read it through, remarked to the Chancellor, "Jolly good, Reggie". This enthusiasm was not shared by those who had to operate it, or pay it.'

By all accounts, Sir John Simon was reflecting a very widely held view. It is to be doubted whether any other tax has been inaugurated under great popular clamour. In the course of the Budget debates, the Chancellor remarked 'it is without precedent in a great war of any country, that the nation has come forward and literally asked to be taxed. There is no better omen for our final success.'

Yet criticism was, at least in some quarters, more wide-ranging than the passage from Basil Sabine's book indicates. In the Preface to the 1920 edition of his book on Excess Profits Duty, the barrister, R.J. Sutcliffe, referred to EPD as having 'many vices'. He wrote:

'It has helped to encourage unwarrantably high wages and prices, from which the country is at present suffering.

It has a clogging effect upon industry, and particularly it acts as a deterrent in the risking of money in new ventures. Traders commencing new businesses wish to see a possible return of 30 or 40 or 50 per cent, on their capital to counterbalance the possibility that they may lose the lot.

It has abstracted from many businesses the profits which under ordinary circumstances would have been put by to provide for the critical time likely to follow the present period of high prices. Trade ebbs and flows in cycles. When it flows traders buy on a rising market and make increased profit. When it ebbs they buy on a falling market and often make large losses. The accumulated profits of the good period enable them to meet those losses. But in the present instance those profits have had to be paid away, and when the bad times come many will be seriously hit.

At the moment the continuance of the duty is probably viewed with mixed feelings. Some think that as the war is now over the duty should cease. Others are already foreseeing, or experiencing, the bad times, and hope to obtain benefit from the continuance of the repayment and set-off provisions.

To most manufacturers the present is an important period in the history of the duty, for there is likely to be considerable heart-burning over deductions to be obtained in respect of depreciation, obsolescence, etc, of plant and other assets, and it is important to those liable for the duty to get proper allowances under this head. Another important question relates to the valuation and realization of stocks, bought at inflated prices, which all hope will not be maintained. In fact, the probability is that, even if the duty is not renewed next year, the questions arising out of it will not be settled for several years'.

Like R.J.Sutcliffe, the writer of this paper is a lawyer. The economic side of EPD will be left to those better qualified to comment. Professor Martin Daunton's book 'Trusting Leviathan' closes at 1914, and the succeeding volume will no doubt have something to say about EPD. This paper will concentrate on the fate of EPD in litigation. It generated over 170 cases. The last of these was decided in 1935, so R.J.Sutcliffe proved absolutely right in believing that EPD would remain a live subject for a considerable time.

A good deal of the case law is easy to find. In 1928 the then editor of Tax Cases, name unknown, was inspired to gather together an array of cases on EPD and on Corporation Profits Tax, a short-lived tax of the early 1920s. His purpose was to report cases 'which may be useful for reference in connection with income tax cases'. Volume 12 of Tax Cases comprises 82 reports, 68 of which were EPD cases. The criteria for inclusion in, or exclusion from, Volume 12, are destined to remain a mystery. Space was, no doubt, a consideration. At 1282 pages, Volume 12 is the biggest in the series, now 73 volumes, of Tax Cases, though in the only recorded instance of use of a volume of Tax Cases as an offensive weapon – in the Royal Courts of Justice a fleeing bail applicant was felled by a volume of Tax Cases propelled by a cricketer of sure aim – a different volume was to hand. Research has unearthed many EPD cases which were reported in other volumes of Tax Cases or elsewhere. A few of the citations given start 'Leaflet No.', and the reference is to a series of leaflets, relating to EPD cases, which was published under the authority of the Board of Inland Revenue.

Before the cases are examined, it will be best to give the briefest summary of the basic framework of EPD. The charge, initially 50 per cent, later 60 per cent and 80 per cent, and applying to accounting periods which ended after 4 August 1914, was imposed on the profits (exceeding £200) of those trades or businesses defined to be within the scope of the tax, in so far as those profits exceeded the pre-war standard as defined, and any EPD paid was a deduction for the purposes of computing liability to income tax (any repayment of EPD being, correspondingly, a receipt for that purpose).

Statutory references will, except where otherwise stated, be to the provisions of the Finance (No. 2) Act 1915.

It is to be borne in mind that this paper will not attempt to cover the full details of EPD because many of the statutory provisions did not give rise to litigation. In that respect the quality of mercy will not be strained. Likewise space constraints necessitate the coverage of each case being very brief.

Sections 38 and 39 – Trade or Business

Sections 38 and 39 are best taken together. Section 39 defined the trades and businesses chargeable under section 38(1) by reference to accounting periods, as defined in section 38(2), and by section 38(3) EPD was rendered continuous in that profits and losses over several accounting periods were to be set off against one another and EPD liability calculated accordingly. The case law generated was considerable.

First, was there a trade or business at all?

In *CIR v The Korean Syndicate Ltd* (1921) 12 TC 181 the company originally operated mining concessions in Korea, but in 1908 had sold out to American firm, though on terms that it would still receive 8 per cent of the profits. The company's only other receipt was of bank interest in respect of the proceeds of sale in 1911 of some shares. The Court of Appeal held that the company was carrying on a business because it was still turning the concessions to account. Some doubt was thrown on the earlier case of *CIR v Marine Steam Turbine Co Ltd* (1919) 12 TC 174 in which a company, whose sole remaining function, following sale of its marine turbine business, was to receive royalties under the sale agreement and to distribute dividends to its shareholders, was held not to be carrying on a trade or business.

The *Marine Turbine* case was distinguished, and the *Korean Syndicate* case was followed in *CIR v Budderpore Oil Co Ltd* (1921) 12 TC 467, so that a company which had been actively engaged in drilling for oil in Assam, but had later sold out to Burmah Oil, though not transferring the whole of its property, was held still to be carrying on a trade or business.

The same issue arose in *CIR v Birmingham Theatre Royal Estate Co Ltd* (1923) 12 TC 580, in which a company, which no longer ran theatres but

just collected the rents on long leases of several properties, was held to be carrying on a trade or business.

Another case in the *Korean Syndicate* line was *CIR v Tyre Investment Trust Ltd* (1924) 12 TC 646. The company acquired in 1917 shares in a Japanese company and in a Canadian company with a view to selling them on to Dunlop Rubber Co Ltd, but the shares had not been sold on by the time of the original hearing in November 1920. Rowlatt J observed a shift in the authorities. He gave no names but presumably he meant the *Korean Syndicate* case, particularly as he went on to refer to 'the darkest days of my error as to the necessity of an active carrying on of business', an error corrected in the *Korean Syndicate* case. But the Judge went on to say that he would always have held that the company carried on a business, as it busied itself in a most active way, occupying itself as an alert and astute shareholder.

CIR v Sangster (1919) 12 TC 208 was, however, a case in which the taxpayer succeeded. The taxpayer, an inventor who had been granted nearly 400 patents, received royalties of some £14,145 from a company, of which he was the managing director and the majority shareholder, which manufactured the articles patented, several of which were war appliances. Rowlatt J held that the income was derived from property, not from a business. The Judge was impressed by the fact that under section 35 EPD was deductible in computing income tax, but the taxpayer's royalties would be taxed without an assessment so that no deduction would be possible. He commented 'It does look as if, in the use of this vague word "business" – and it is very unfortunate that in Taxing Acts they do use words which are essentially the vaguest in the English language – they were not glancing at anything more than what is taxable under Case I of Schedule D'.

We now come to the famous case of *Cape Brandy Syndicate v CIR* (1921) 12 TC 358. Three individuals, who were members of different firms in the wine trade, combined to buy on joint account 3,100 casks of cheap brandy from the Cape Government and arranged for their firms to blend it with French brandy, sell the blend as 'Old Vatted Brandy', deduct normal commissions, and pay over the net receipts. This took place over some 18 months from March 1916 to September 1917. The case is perhaps unique in that the name of the appellants seems to have been an invention, for convenience, of the Inland Revenue: see page 360. The first issue, whether the three individuals had carried on a trade or business, attracted an affirmative answer. The second issue was whether, as the enterprise did not exist prior to 4 August 1914, it was chargeable to EPD anyway, and this raised difficult points of statutory construction. Rule 4 Part II Sch 4, on which the Crown relied, proved ambiguous, and it was in this connection that Rowlatt J uttered his celebrated dictum '… in taxation you have to look simply at what is clearly said. There is no room for any intendment; there is no equity about a tax; there is no presumption as to a tax; you read nothing in; you imply

nothing; but you look fairly at what is said and at what is said clearly and that is the tax.' But an alternative argument of the Crown found favour. Rowlatt J, and Lord Sterndale MR and Younger LJ in the Court of Appeal, all held that later legislation showed that the 1915 Act did apply to trades or businesses commenced after 3 August 1914, *Attorney-General v Clarkson* [1900] 1 QB 156 being cited as authority for using subsequent legislation to determine the meaning of earlier legislation where that earlier legislation is ambiguous. Scrutton LJ preferred to rest on the fact that the assessment fell under the 1916 and 1917 Acts and, as the 1916 Act was clear on the point, it was not necessary to determine the construction of the 1915 Act.

In *Representatives of P.J. McCall (deceased) v CIR* (1923) 4 ATC 522 a Dublin publican bought whiskey from a distillery, used some in his publican business, and sold the rest back to the distillery under an arrangement which initially involved interest but later involved fixed prices. The transactions under that arrangement were held to be trading transactions, not investments, the Irish High Court describing the case as a stronger one than *Cape Brandy Syndicate*.

In *Martin v CIR* (1927) 11 TC 297 the taxpayer, a merchant of agricultural machinery, bought 45 million yards of surplus Government aircraft linen. Over seven months, through a large and skilled organisation, he sold the linen to well over a thousand purchasers, making a profit of some £1.6m. In these circumstances the contention that he was not trading may be viewed as a second exercise in speculation, and it is not surprising that it did not share the success of the first. In relation to income tax the appellant also relied on the contention that his profits were not 'annual profits or gains', but the House of Lords, upholding the view of Rowlatt J in *Ryall v Hoare* [1923] 2 KB 447, held that the words meant simply the profits or gains accruing in the year in question.

In *Rutledge v CIR* (1929) 14 TC 490 a moneylender was held to have been engaged in an adventure in the nature of a trade in respect of his purchase of one million rolls of toilet paper for £1,000, on sale of which he achieved a net profit of £10,895.

In *Pickford v Quirke (and CIR)* (1927) 13 TC 251 the taxpayer, a manager of one spinning company and director of another, formed, on four occasions, syndicates to acquire cotton mills and dispose of them to a new company, and these activities were held to comprise a business. This case was similar on its facts to the earlier case of *Mellor v CIR* (1925) 4 ATC 318, but in that instance the Crown's case failed, because the assessments were in respect of the taxpayer's stockbroking business and the profits were found not to have been profits of that business.

In *J & R O'Kane & Co v CIR* (1922) 12 TC 303 the issue was whether a trade was still up and running during a period in which the partners were winding down activities with a view to retiring. They were held to be still trading because they were still using 'the ordinary method of carrying on

trade modified only by arrangements which were merely part of the machinery of business dealing adopted to effect their intention to retire'.

In *Cohan's Executors v CIR* (1924) 12 TC 602 the executors of a deceased shipbroker established that they were not liable to EPD in respect of the profits of two transactions, one of which was completed before the death and one after. The EPD provisions had not included any equivalent of the income tax provisions which rendered personal representatives subject to assessment for tax, so the Crown's case was dependent on the executors having themselves carried on a trade or business. The Court of Appeal held that they had done no more than to realise the deceased's estate to best advantage. By contrast, in *Weisberg's Executrices v CIR* (1933) 17 TC 696 the personal representatives were held, on the facts, to have carried on the deceased's business after his death.

In *Birmingham & District Cattle By-Products Ltd v CIR* (1919) 12 TC 92 the issue resolved was the date on which the taxpayer company had started to trade. It was the later of the two dates considered, earlier work having been merely preparatory.

In *Port of London Authority v CIR* (1920) 12 TC 122 the Authority was held to be carrying on a trade or business, and it was established that the Revenue had misconstrued the rules in deciding that the Authority was not entitled to have its pre-war profits standard fixed by reference to the capital employed at the end of the last pre-war year under section 40(2).

Secondly, did the right to a repayment in respect of a deficiency extend to losses incurred by a predecessor in a trade or business? In *Gittus v CIR* [1921] 2 AC 81 and in *Wood v CIR* 1925 SC 144 it was decided that neither section 38(3) nor other provisions in the EPD and Income Tax codes produced a favourable answer for the taxpayer. Correspondingly it was held in *CIR v Walter Somers Ltd* (1924) 3 ATC 481 that a successor company could not set deficiencies against the profits of the predecessor company and achieve a repayment of EPD paid by the predecessor company.

It is convenient to mention here *Far Famed Cake Co Ltd v CIR* (1921) 1 ATC 263. Several accounting periods had produced a mixture of excess profits and of deficiencies, and the company sought to have EPD exacted at 64.33%, that being the average of the 50%, 60% and 80% rates during the whole period. But it was held that each accounting period was to be considered separately.

Thirdly, was there a single business or were there multiple businesses? This question arose because, apart form a limited concession, a profit in one business could not be set off against a deficiency in another. In *Birt, Potter & Hughes Ltd v CIR* (1927) 12 TC 976 shipbrokers failed to establish on the facts that their activities comprised a single business. In *B W Noble Ltd v CIR* (1926) 12 TC 911 a London insurance company also carried on business in Paris. The Special Commissioners held that the Paris

business was a separate business from the London business. The Crown did not pursue an appeal on this point. In *Fred W Millington (1920) Ltd v CIR* (1927) 12 TC 1081 the business had changed hands and the company failed on the facts to show that that had occurred later than 25 October 1920. This also affected a claim for stock relief under section 38 and Rules 1 and 7 Part I Sch 2 Finance Act 1921.

Fourthly, did any of the exemptions in section 39(a)–(c) apply?

Under (a) 'husbandry' was exempt. This gave rise to two cases, in both of which the Courts rejected the Crown's approach and adopted a wide meaning of the term.

In *CIR v Cavan Central Co-Operative Agricultural and Dairy Society Ltd* (1917) 12 TC 1 the company ran a creamery business. Madden J found help in a book by J. Tusser, published in 1557 and entitled 'The Five Hundred Points of Husbandry', a book which he described as 'a quaint rhyming production'. The book established that 'husbandry' had acquired a more extended signification than the mere cultivation of the soil, and covered many allied industries such as malting, brewing, candle-making, weaving and baking, carried on by farmers and members of their households. The Court held, though, that these activities were not 'husbandry' if they were 'divorced from the occupation of the soil' and carried out by persons other than farmers, so the company's claim to exemption failed.

In *CIR v William Ransom & Sons Ltd* (1918) 12 TC 21 the company ran a business as manufacturing chemists and herb growers. The herbs were grown on a farm and then taken to the factory for use in the distillation operations, while other produce of the land was sold to the public. The company succeeded in a contention that the farm business should be regarded as a separate business and one within the exemption on the footing that it was engaged in tilling the soil and producing commodities for human consumption, though not food.

Under (b) 'offices or employments' were exempt. In *Robbins v CIR* [1920] 2 KB 677 it was held that the exemption covered a whole-time employee. In *B W Noble Ltd v CIR*, mentioned above, the Special Commissioners held that the company's Paris business was not conducted as servant for various companies, and the company did not pursue an appeal on that point.

Under (c) exemption was conferred on 'any profession, the profits of which are dependent mainly on the personal qualifications of the person by whom the profession is carried on and in which no capital is required, or only capital expenditure of a comparatively small amount …'.

In *CIR v North and Ingram* [1918] 2 KB 705 preparatory boarding-school masters, were held to be carrying on a profession within section 39(c). The school-masters concerned had in fact bought the school for £23,297, but Sankey J held that the reference to 'capital expenditure' was not to

capital actually being used, but generally to capital expenditure required for a profession of the relevant kind.

In *Christopher Barber & Sons v CIR* [1919] 2 KB 222 (the report mis-entitles the firm as 'Christopher Barker & Sons) Rowlatt J held that a firm of stockbrokers, which, in addition to buying and selling shares, gave advice and made valuations, was not carrying on a profession within section 39(c).

In *William Esplen, Son and Swainston Ltd v CIR* (1919) 2 KB 731 Rowlatt J held that, as an incorporated company could not have, and exercise, professional qualifications, the exemption could not apply to a company even if its shareholders were all professional men (in this instance, naval architects) and the character of the company's work was the same as that done by professional men.

In *CIR v Peter McIntyre Ltd* (1926) 12 TC 1006 the Court of Session agreed with the *William Esplen* decision and held that a company, whose business was that of agricultural and general auctioneers, livestock salesmen, agents, farm managers, appraisers, valuators and land measurers, and which was a family company run by a majority shareholder, was not within the exemption. The company had relied on an agreement between the Revenue and the Surveyors' Institution and the Auctioneers and Estate Agents' Institute made in 1919, but the Judges held that that agreement was not inconsistent with the denial of the exemption, and the Lord President (Lord Clyde) and Lord Blackburn said that it would have been *ultra vires* if it had done so.

In *Cecil v CIR* (1919) 36 TLR 164 the appellant was a specialist photographer or, as he put it, an artist in photographic work. Rowlatt J held that the word 'profession' in section 39(c) could not be exhaustively defined, but added that, for the purpose of the present case, a man did not exercise a profession unless he exercised an art, the profits of which were dependent mainly on his personal qualifications. After reviewing the facts, the Judge felt unable to disturb the decision of the Special Commissioners in favour of the Crown. The Court of Session took the same view in *Crooke v Easson* 1920 SC 721.

CIR v Maxse (1919) 12 TC 41 is an instance of the wisdom of Solomon prevailing. The taxpayer was sole proprietor, editor and publisher of, and a major contributor to, the 'National Review', a publication which had for many years up to 1914 unavailingly sought to convince people that the German Government was pursuing an aggressive policy and intended to attack the United Kingdom. The Court of Appeal, relying on the *William Ransom* case as an authority for severance, held that the exemption in section 39(c) applied so that, in determining the taxpayer's profits in his trade as publisher a reasonable allowance was to be made for his professional services as editor and journalist.

In *CIR v Marx* (1925) 5 ATC 25 the trading activities of the taxpayer, an engineer and inventor, were threefold, and two elements (the receipt of

royalties from licences to use his patents, and the provision of his services as a consulting engineer) were exempt. In relation to the third branch, a manufacturing and selling enterprise, the taxpayer claimed a deduction in respect of the amount of royalties which would have been payable for the use of patents, had he, the licensor, not been the patent-holder. The judges held that the third branch was not severable in such a way as to bring the principle in the *Maxse* case into operation.

In both *Currie v CIR* and *Durant v CIR* (1921) 12 TC 245 the taxpayers concerned were held not to be carrying on a 'profession'. Mr Currie was an income tax agent, preparing tax returns and claims for repayment, and he also did the ordinary work of an accountant. He was not a member of any organised professional body, but from time to time employed a chartered accountant as a member of his staff. Mr Durant was an insurance broker, and he acted as a surveyor valuer and appraiser in connection with his insurance work. He was not a member of the Surveyor's Institution, but he was a founder of, and was on, the Council of the Corporation of Insurance Brokers and Agents.

Fifthly, was a trade or business nevertheless within the scope of EPD by virtue of the full-out words of section 39, which read 'but including the business of any person taking commissions in respect of any transactions or services rendered, and of any agent of any description (not being a commercial traveller, or an agent whose remuneration consists wholly of a fixed and definite sum not depending on the amount of business done or any other contingency)'.

In *Burt & Co v CIR* [1919] 2 KB 650 general merchants and commission agents acted as secretaries and/or agents for Eastern produce companies in return for a small fixed annual sum and commissions on sales of produce effected by brokers on the firm's instructions; the firm was also an expert adviser to a Chinese company in return for a fixed remuneration and a small commission on sales. On those facts, and notwithstanding that the firm did not itself make the sales which generated the commissions, the full-out words were held applicable. The same result was reached in *Radcliffe v CIR* (1921) 125 LT 290, in which the taxpayer acted as manager to four steamship companies, which he had himself promoted, at a management fee of 2½% (or 7½% if the ship was on time charter), and a broker's fee of 5%. The same result was also reached in *CIR v Turnbull, Scott & Co* (1924) 12 TC 749 in which shipbrokers and managers of ships were, in respect of their management of three commandeered ships which were 'seized neutrals' at fixed fees payable by the Ministry of Shipping, held to be conducting a separate business.

Under the parenthesis in the full-out words a 'commercial traveller' was not chargeable. In *Binney v CIR* [1920] 3 KB 348 Rowlatt J held that the expression was not limited to a person between whom and the person for whom he travelled the relationship of master and servant existed.

The appellant was an agent for the sale of thread, twine and rope, and he travelled extensively for work purposes. The Judge dismissed as irrelevant the fact that he had an accommodation address in London, and held that it made no difference that the appellant employed others to work as sub-agents for him.

In *Moorhead, Sons & Co Ltd v CIR* 1924 SC 345 the Court of Session, overruling a decision of the Special Commissioners, held that the exemption of 'a commercial traveller' was not limited to individuals, but might apply to companies.

In *A J Hamilton & Co Ltd v CIR* (1928) 7 ATC 89 the self-same issue arose. The company was the agent of eight manufacturers. Three directors and four employees travelled to obtain orders. The goods were invoiced and delivered direct by the manufacturers to the customers, and the customers made payment direct to the manufacturers. The company maintained an office in London, but it did not handle or keep goods. Rowlatt J, reversing the decision of the General Commissioners, held that the exemption applied. His decision was reversed by the Court of Appeal but, by a majority of four to one, was restored by the House of Lords. The divide was over the issue whether the statutory wording was directed to the business or to the person who conducted the business. The dissentient, Viscount Sumner, took the view that the section started by dealing with businesses, but in its later wording 'abruptly' passed from the business to the person who engages in the business. Lord Buckmaster, with whom Lord Carson agreed, Lord Wrenbury and Lord Warrington of Clyffe held that the wording related to the business, and not to the person who carried it on, Lord Warrington saying that this applied throughout the Act. Lord Buckmaster alone mentioned the *Moorhead Sons & Co Ltd* case, which he considered was rightly decided.

M F Findlay & Co v CIR 1928 SC 218 was another case on the same issue. The Lord President (Lord Clyde) suggested that a business would be that of a commercial traveller if 'that element or department is .... predominating'. The taxpayer firm lost the case on the facts, as an appreciable part of its business was conducted by methods other than those of commercial travelling.

Computation: (1) The Basic Rule in Section 40(1)

Unsurprisingly the computation provisions were complex and generated much case law. Subject to qualifications which will be described, the basic rule, in section 40(1), was that profits were to be computed in accordance with Income Tax principles. Thus settled Income Tax case law came into play. Further, it was in the taxpayer's interest to establish that profits were as high as possible for pre-war periods but as low as possible in wartime periods, so the cases show taxpayers arguing that receipts were on revenue

rather than capital account for pre-war periods, but *vice versa*, for wartime periods. Perforce the cases must be described very succinctly.

First, there were cases in which the issue was whether receipts were trade receipts at all.

In *Sutherland v CIR* (1918) 12 TC 63 the receiving of rent paid by the Admiralty in respect of a requisitioned boat was held to be an activity of the business of employing ships for profit, not compensation following the ending of a business.

In *Chibbett (also CIR) v Joseph Robinson & Sons* (1924) 9 TC 48 a sum of £50,000 paid to a firm of shipping managers by a shipping company which went into liquidation was held to be compensation for loss of office and not to be a chargeable profit.

In *Short Bros Ltd v CIR and Sunderland Shipbuilding Co Ltd v CIR* (1927) 12 TC 955 payments in respect of cancelled orders were held to be trade receipts attributable to the period in which the payment was made.

In *CIR v Northfleet Coal and Ballast Co Ltd* (1927) 12 TC 1102 receipts in respect of cancellation of contracts were held to be trade receipts.

In *Charles Brown v CIR* (1930) 12 TC 1256 sums paid by the Food Controller to millers whose receipts fell short of the prescribed standard were held to be trade receipts.

Secondly, there were the cases in which the issue was whether receipts were on revenue or on capital account.

In *Glenboig Union Fireclay Co Ltd v CIR* (1922) 12 TC 427 compensation paid for sterilisation of an asset was held to be a capital receipt.

In *British Dyestuffs Corporation (Blackley) Ltd v CIR* (1924) 12 TC 586 payments for rights to exploit patents were held to be income receipts.

In *Rees Roturbo Development Syndicate Ltd v CIR* (1928) 13 TC 366 the appellant company operated, in conjunction with the inventor, to exploit patents relating to centrifugal pumps. Largely the business was concerning with granting manufacturing licences. But the company always contemplated the possibility of a sale of its interest in the foreign patents and, when a United States patent was sold, this proved fatal to a contention that the proceeds of sale represented a capital asset rather than a revenue receipt.

In *Brandwood v Banker (and CIR)* (1928) 14 TC 44 an inventor, who sold machines together with a limited right to exploit his patents, failed in a claim that the profits relating to the patent licence were a severable capital item.

In *George Thompson & Co Ltd v CIR* (1927) 12 TC 1091 payments by ship charterers to the owner of sums for depreciation and by way of share of net profits of voyages, and receipts in respect of surplus coal, were held to be revenue receipts.

In *Ensign Shipping Co Ltd v CIR* (1928) 12 TC 1169 sums of compensation paid to shipowners for detention of ships were held to be trade receipts.

Thirdly, there were the cases on whether expenditure was of a revenue or a capital nature.

In eight cases expenditure was held to be capital, rather than revenue. *Charles Marsden & Sons Ltd v CIR* (1919) 12 TC 217 concerned a loan to a supplier, *John Smith & Son v Moore* (1921) 12 TC 266 concerned a payment to secure inheritance of a business, *Small v Easson* (1920) 12 TC 351 concerned legal expenses relating to a loan, *Law Shipping Co Ltd v CIR* (1923) 12 TC 621 concerned the cost of repairs to ships, *Lothian Chemical Co Ltd v Rogers (and CIR)* (1926) 11 TC 508 concerned the cost of conversion of a chemical works, *Fitzgerald v CIR* [1926] IR 182 concerned the cost of rebuilding business premises destroyed during the 1916 rebellion in Dublin, and related expenditure, *CIR v Huntley & Palmers Ltd* (1928) 12 TC 1209 concerned acquisition by a parent company of raw materials for use by a subsidiary which was in financial difficulties, and *Morgan Crucible Co Ltd v CIR* (1932) 17 TC 311 concerned the cost of a policy for annuities payable to the company to fund payments of pensions to former employees. Likewise in *CM Legg & Son Ltd v CIR* (1920) 12 TC 391 a loss was held not deductible because it was a capital loss.

Fourthly, there were cases on whether expenditure was, or was not, trading expenditure.

In *Pegg and Ellam Jones Ltd v CIR* (1919) 12 TC 82 bonuses paid to directors were held to be a distribution of profits rather than a trading expense, and an instalment of bonus was held not to be deductible where it was paid in a year during which the recipient, who had retired, was not a director.

In CIR v Anglo Brewing Co Ltd (1925) 12 TC 803 compensation and pensions paid to staff after a business closed were held not to have been made for the purposes of the company's trade and in any event were not attributable to the earlier period in which the decision to pay was made.

In *CIR v EC Warnes & Co Ltd* (1919) 12 TC 227 and *CIR v Alexander von Glehn & Co Ltd* (1920) 12 TC 232 penalties paid to Customs & Excise in respect of export infractions were held not to have been outlays made for the purpose of earning profits.

In *Adam Steamship Co Ltd v Matheson* (1920) 12 TC 399 calls paid to an indemnity association were, subject to a remitter for further evidence, held not to have been incurred wholly and exclusively for the purposes of the trade.

Fifthly, a string of cases raised timing issues.

In *Fassett & Johnson Ltd v CIR* (1919) 4 ATC 89 bad debts, partly and provisionally written off in accounts to September 1914 and June 1915, were finally written off in the accounts to June 1916. Rowlatt J upheld the decision of the Special Commissioners, who held that, 'in accordance with ordinary commercial principles' (of which no evidence appears to have been given), the amounts written off in the earlier periods should not be transferred so that, instead, they were written off in the 1916 accounts.

In *J P Hall & Co Ltd v CIR* (1921) 12 TC 382 the date when the profit on a contract should be brought into account was held to be the date of

delivery of goods manufactured, not the earlier date of the sale contract. This decision (also *J H Young* discussed below by reference to Rule 5 Part I) was followed in *Wright Sutcliffe Ltd v CIR* (1929) 8 ATC 168 on facts which, once a rather bizarre commercial arrangement had been disentangled, were essentially similar.

In *Isaac Holden & Sons Ltd v CIR* (1924) 12 TC 768 it was held that commissions must be brought into account for the period in which they were earned even though they were paid later.

Likewise in *CIR v Newcastle Breweries Ltd* (1927) 12 TC 927 – contrast *Arthur Guinness, Son and Co Ltd v CIR* [1923] 2 IR 186 – compensation for requisitioned rum was held to be a trade receipt in the period of requisition even though paid later.

Repayment in 1924 of a charge of £8,236 levied by the Food Controller in 1920 but established in later litigation to have no basis, was held in *English Dairies Ltd v CIR* (1927) 6 ATC 503 to be an assessable receipt in the accounting period ended in 1920.

In *Lambert Bros Ltd v CIR* (1927) 12 TC 1053 payments received by coal merchants following a dispute about ownership of surplus coal and about address commissions were held to be attributable to the periods in which the surplus accumulated and the commissions were earned rather than the later period in which a compromise was reached.

In *Jesse Robinson & Sons v CIR* (1929) 12 TC 1241 receipts of compensation relating to defaults by purchasers were held to be trading receipts in the period in which the default occurred.

In *H Ford & Co Ltd v CIR* (1926) 12 TC 997 a contingent liability was held not to be deductible in computing profits.

Correspondingly in *Naval Colliery Co Ltd v CIR and Glamorgan Coal Co Ltd v CIR* (1928) 12 TC 1017 the cost of reconditioning mines was held not to be deductible before the expenditure was actually laid out.

In *CIR v Bell* (1927) 12 TC 1181 it was held that payments to employees could not be referred back to a period earlier than that of payment. Likewise in *Worsley Brewery Co Ltd v CIR* (1932) 17 TC 349 fees paid to accountants in 1930 in respect of work which had secured a repayment of EPD were held not to be referable back to, and admissible as deductions in, the relevant EPD periods.

In *Bernhard v Gahan (and CIR)* (1928) 13 TC 723 additional assessments were upheld, by which corrections were made when a trader's liability to a bank, originally estimated at £22,410, was ultimately compromised at £8,000.

In *CIR v Hugh T Barrie Ltd* (1928) 12 TC 1223 a loss ensuing from the company's breach of contract was attributed to the period in which the breach occurred, not the later period when the dispute about the breach was resolved.

In *Rownson, Drew and Clydesdale Ltd v CIR* (1931) 16 TC 595 the three issues all concerned whether computations were to be affected by events which

occurred after the relevant accounting periods. Rowlatt J formulated the test as being whether the later event 'is to be treated as a case ..... of having corrected the transactions of the year as in the year itself, or whether it is to be treated as a countervailing independent piece of good fortune in a subsequent year which replaced the losses of the bad fortune of a previous year'. On the facts the company's resistance to corrective treatment failed on the first two issues, an insurance payment, and a payment under a variation of contract, but succeeded on the third, a contractual term by which the company received extra payments geared to shortage of turnover and economies of expenses.

Sixthly, the rule that losses could not be anticipated was applied in *Edward Collins & Sons Ltd v CIR* (1924) 12 TC 773, in relation to an adjustment for a shortfall between market value of goods not delivered and the price payable, and in *Whimster & Co v CIR* (1925) 12 TC 813 to other accounting adjustments.

Seventhly, there was a miscellany.

A general claim that there was a principle of assimilation between the conditions appertaining to the pre-war standard and those of the relevant wartime period was rejected in *Inland Revenue v Guthrie, Craig, Peter & Co Ltd* (1918) 55 SLR 659 on the grounds that the statutory provisions did not embody such a principle.

In *Charles Clifford and Son Ltd. v Puttick (and CIR)* (1928) 14 TC 189 manufacturers bought raw materials from a trade association which had acquired surplus stock from the Ministry of Munitions, and the purchase price was held fully deductible and not to be reduced by an element of profit accruing to the trade association from which the manufacturers might ultimately benefit.

In *Brigg Neumann & Co v CIR* (1928) 12 TC 1191 issues were resolved about the value of defective cloth in the context of special arrangements which the textile company had with the supplier weavers.

In *Guardian Assurance Co Ltd v CIR* (1929) 8 ATC 57, it was held that section 11 Finance Act 1915, by which life assurance business had been designated as separate for income tax purposes from other insurance business, constituted a principle within section 40(1). The company also failed in a contention that losses of the life assurance business might be set against the profits of the remaining business. This was the very point already decided in the Crown's favour by the Court of Session in the *John Wood* case and by the Court of Appeal in the *Birt, Potter & Hughes Ltd* case (both discussed above), and the House of Lords took the same view.

Computation: (2) – Special Rules

The basic rule, application of income tax principles, was filled out by sections 40–42 and Schedule 4, which comprised three Parts, the paragraphs of

which were often referred to as Rules. Before consideration of those Rules, cases arising under Section 40(3) and Section 41 will be mentioned.

Section 40(3) – Modification of the Rules in Schedule 4

Section 40(3) empowered modification of the Rules in Schedule 4 in relation to various prescribed circumstances, including exceptional depreciation of assets due to the war. In *A Lloyd & Sons Ltd v CIR* (1930) 9 ATC 144 the company failed in a claim in respect of its goodwill. The business was to make containers for the tea export trade. That business declined during the war, and apparently it would never revive because the tea growers took to selling direct rather than via the entrepot trade. Doubts were expressed whether goodwill fell within section 40(3) at all, but the Board of Referees' decision against the company was upheld on the footing that it was a finding of fact that the loss of business was due to the tea growers' change of practice rather than due to the war.

Section 41 – Adjustments of Capital

Section 41 provided for situations in which there were adjustments of capital, whether increases or decreases, and whether during a wartime accounting period or during a pre-war period relevant to ascertainment of the pre-war standard.

In *J & P Hutchinson v Bensted* (1920) 58 SLR 114 the issue was how to compute 'the average amount of capital employed during the pre-war trade years' within section 41(3), there having been several increases of capital during the period. Rejecting the methods adopted by the firm and by the Crown, the Court of Session held that in the case of each introduction of fresh capital the amount and date must be ascertained, and the average should be calculated from there.

Section 41(4) directed an addition to the profits standard where any capital was employed in a trade or business for the first time within three years before 1 August 1914 and it only commenced to be fully remunerative in the accounting period. The sub-section gave rise to several cases.

In *Calcutta Electric Supply Corporation Ltd v CIR* (1925) 4 ATC 51 the company succeeded in establishing that capital invested in a new generating station had not become fully remunerative in pre-war periods. The company's primary contention was that 'fully remunerative' meant the reasonable commercial rate of profit which the capital could be expected to show, which it put at 12%. That contention failed, but the company succeeded in its alternative contention that the reference was to the statutory

percentage, which was in this case 7%. Rowlatt J seemed to accept that, on a literal construction of the provision, the Crown would succeed because the company was already making over 7% by the end of the last pre-war year, but on considering what he called 'the general scope of the thing', he determined that the right period to look at was the two year (1912 and 1913) period, so that the emergent figure was 5% and the company succeeded.

In *CIR v Loders and Nucoline Ltd* (1926) 6 ATC 234 and *CIR v Ellangowan Paper Co Ltd* 1927 SC 723 it was held that, where capital had become employed in the business only during the accounting period in question, the relief in section 41(1) would apply, but the relief in section 41(4) would not apply as it referred to capital employed in the business before the beginning of the accounting period. In *Stagg & Mantle Ltd v CIR* (1927) 6 ATC 839 the company succeeded in showing that expenditure on the purchase and reconstruction of premises had antedated, but did not become fully remunerative until, the accounting period concerned, but a sinking fund, by way of provision against the wasting value of leasehold property, was held not to be capital employed in the business.

We now come to the Rules in Schedule 4.

Part I comprised modifications of the basic rule.

Rule 2 disapplied the principle that deductions were not allowed for interest and that the 'profits or gains arising from land, tenements, or hereditaments forming part of the assets of the trade or business were excluded'. In *Weller v CIR* [1919] 2 KB 407 brewers had accepted low rents for tied houses in order to increase their sales. The amount by which the rents fell short of the annual value for Schedule A purposes was deductible for Schedule D purposes, and therefore deductible for EPD unless Rule 2 applied. Rowlatt J held that Rule 2 did not apply because only the actual rent, and not that amount plus the sacrificed rent, fell within the wording of Rule 2.

A W Walker & Co v CIR (1920) 12 TC 297 involved a loan agreement under which an element of the payments was geared to the profits of the business, and that element was held not to be interest and was therefore not deductible.

CIR v Hansons Ltd (1924) 3 ATC 321 also concerned a brewer which sub-leased public houses at a relatively low rent for the benefit of securing a tie. In relation to deficiencies in the rents payable to the company under sub-leases as against the rents payable by the company under the leases, Rowlatt J held that no deduction was available under Rule 2, because there was no emergent figure which was excluded by the Income Tax Acts, within the opening words of Rule 2, and that the later part of Rule 2 was simply to the effect that the EPD computation must bring in income tax profits on land and gains which are not brought into a trading account.

Rule 5 Part I provided that 'Any deduction allowed for the remuneration of directors, managers, and persons concerned in the management of the trade or

business shall not, unless the Commissioners of Inland Revenue, owing to any special circumstances, or to the fact that the remuneration of any managers or managing directors depends on the profits of the trade or business, otherwise direct, exceed the sums allowed for the purposes in the last pre-war trade year or a proportionate part thereof as the case requires ....'.

In *R v CIR, ex parte William France Fenwick & Co Ltd* [1918] 1 KB 143, *Williamson Film Printing Co Ltd v CIR* [1918] 2 KB 720 and *CIR v Auld, Pemberton & Co Ltd* [1919] 2 IR 66 it was held that the power was discretionary and no right of appeal lay from decisions relating to the power.

Nevertheless three other cases related to Rule 5. In *Johnson Brothers & Co v CIR* (1919) 12 TC 147 three sons were found to be their father's partners, not his employees, in a business of waterproofing materials. In *Glanvill, Enthoven & Co v CIR* (1925) 41 TLR 258 an employee of underwriting agents, earning a fixed salary and commission as authorising underwriting clerk for the purpose of accepting or rejecting marine risks offered by insurance brokers, was held to be within Rule 5 as it was on his skill and judgment that the success or failure of the business depended, and he was in control of an essential part of the business. In *Thos Hinshelwood & Co Ltd v CIR* (1920) 12 TC 417 an additional assessment was made when the Revenue learned that deductions in the original computation had included commissions paid to managing directors, commissions which exceeded the allowable pre-war figures. The company's contention was that the Revenue had originally exercised the discretion to allow greater amounts, but that contention was dismissed as 'hopeless'.

Tacked on to Rule 5 Part I was an anti-avoidance rule – see also section 44(3) which included liability to a criminal penalty. The rule cancelled the effect of any transaction or operation which would artificially reduce profits for EPD purposes.

In *Scottish Adhesives Co v CIR* (1922) 1 ATC 42 the issue was whether a certain transaction was a transaction which artificially reduced the profits within the Rule. The appellant firm had comprised three partners. One was responsible for the manufacture and sale of the goods, and he was entitled to half of the profits. The other two, who were separately in business as chartered accountants, were engaged mainly in the clerical and accountancy work of the firm, and each was entitled to a quarter of the profits. The change in issue occurred in 1916. By it the partnership was dissolved, the main partner took over the business, and the two accountants became employees, their duties being the same as before.

By a 21-line judgment the Lord President, with whom the other three judges of the Court of Session concurred, dismissed the firm's appeal against the Special Commissioners' decision in favour of the Crown. He concluded that the Commissioners had ample ground upon which they could reasonably arrive at the result that the character of the transaction was that it artificially reduced the profits within Rule 5.

It is tempting to speculate whether the change took the form of more than one agreement. This seems likely. The Lord President's wording concentrates on the agreement by which the accountants became employees. It is difficult to see how the result of the case could be reached without regard being had to the other components of the change. Perhaps an opportunity was missed for an earlier emergence of the principle in *W T Ramsay Ltd v CIR*.

In *J H Young & Co v CIR* (1925) 12 TC 827 the firm, muslin manufacturers, adjusted its accounts, following a steep drop in the price of yarn, to substitute market price for the amount actually payable under forward purchase contracts. The Court of Session applied the normal rule that losses in a future year could not be anticipated, but also held that the anti-avoidance rule applied.

The only other case in which the anti-avoidance rule figured was the *Huntley & Palmers* case mentioned earlier in relation to the Crown's success on ordinary principles. Alternative reliance had been placed on the anti-avoidance rule and Rowlatt J, referring to controversy about the word 'artificial', said 'I find it very difficult to see what that means, and I will not complicate this case by saying anything about that'.

The effect of **Rule 6** Part I was to treat as a single business any situation in which a company and its wholly owned subsidiary company were 'carrying on the same trade or business'. In *Dunlop Rubber Co Ltd v CIR* [1919] 2 KB 794, the appellant manufactured rubber tyres and other goods, and its subsidiaries owned and cultivated rubber estates from which the rubber was supplied to the appellant. Rowlatt J held that Rule 6 referred to companies which were 'in the same line of business' and did not extend to cases such as *Dunlop*, in which different lines of business might be aggregated to form one business carried on by the group though not by any one company within the group.

The same result was reached in *Scandinavian Belting Ltd v CIR* (1919) Leaflet No. 40 in which a wholly owned American company was the taxpayer company's agent for selling goods which were manufactured by the taxpayer company, and the American company also sold other goods.

In *T and J Brocklebank Ltd v CIR* (1926) 5 ATC 215 it was held that Rule 6 did not extend to provide for assessment together not just of the profits of a parent company and its wholly owned subsidiary but of the profits of a sub-subsidiary company as well.

The consequence of Rule 6 was that EPD charged with reference to the deemed single business was wholly deductible for income tax purposes in relation to the parent company. In *Ogston v Reynolds, Sons & Co. Ltd.* (1930) 15 TC 501 it was held that, in so far as such a deduction was unexhausted when a parent company went into liquidation, none of it could be attributed to the subsidiary.

By **Rule 7** Part I a trade or business, which had adopted the percentage standard as its pre-war standard, and which had made a net loss in the last

three pre-war trade years, was entitled to a deduction to the extent that part of its profits had been applied in extinction of the loss. In *Kosmos Photographics Ltd v CIR* (1919) 1 ATC 61 the issue was whether the conditions in Rule 7 were met on the facts. A business was sold in 1914 by the liquidator of the company which had run it. The purchaser was a newly incorporated company of the same name. The shareholders of the new company were, apart from a bank, the same as the old shareholders, though in different proportions. The profits of the new company were not distributed but were kept in the business. This last point was decisive of the matter. Rowlatt J's decision in favour of the Crown turned on the fact that the profits simply had not been applied in extinction of the pre-war loss as required by the Rule.

By **Rule 8** Part I no account was to be taken, in computing profits, of income received from investments except in the case of life assurance businesses and businesses where the principal business consisted of the making of investments. In *Irish Catholic Church Property Insurance Co Ltd v CIR* (1918) 12 TC 13 the company, which carried on a fire insurance and employers' liability insurance business, failed in a contention that it fell within Rule 8. It was also decided that its accumulated profits, which had been invested and formed a reserve fund, could not be treated as capital employed in the business. Further it was held that the Assurance Companies Act 1909 did not oblige replacement of capital lost by depreciation in securities, so the company was not entitled to an allowance out of profits to make good such depreciation.

Rule 11 Part I provided a special rule for long-term contracts. For contracts extending beyond an accounting period, and only partially performed in an accounting period, a proper attribution of profits to the period was to be made, unless the Revenue, owing to any special circumstances, otherwise directed. In *London Theatre of Varieties Ltd v CIR* (1930) 9 ATC 512 the issue was whether this rule applied to long-term contracts for the engagement of star artistes on weekly salaries. The contracts were made in wartime but extended to the post-war period in which, as it happened, rates had fallen and the contractual pay exceeded what the artistes could otherwise have commanded. Rowlatt J upheld the General Commissioners' decision in favour of the Crown. He held 'It is not a question of indivisible contracts spread over a long time which have to be divided and apportioned to do justice; it is a series of separate engagements made forward .... I do not think it is anywhere near what is meant by the Rule'.

Part II contained rules for the computation of profits of a pre-war trade period, the fundamental rule being to apply the same principles as for wartime periods.

Rule 4 dealt with circumstances in which the trade or business had not been running long enough for there to have been three pre-war trade years. In *Cannop Coal Co Ltd v CIR* (1918) 12 TC 31 the company had operated

a coal drift since 1908 and its claim that the trade did not start till 1 July 1912, on the ground that only then had the output of coal become significant, was rejected.

The second paragraph of Rule 4 provided a special rule for ascertaining the pre-war standard of profits in the case of an agency or business of a nature involving capital of a comparatively small amount. Under the Rule reference could be made to the profits arising from any earlier trade, business, office, employment or profession of any sort. In *Wyatt v CIR* (1927) 6 ATC 875 the issue was whether the earnings of an employment could form the pre-war standard even though that employment occurred in wartime rather than pre-war. The taxpayer had been an employee until July 1918 when he started a business of his own. He wanted his earnings of 1917 to be the basis, but it was held that the direction in Rule 4 was to a pre-war period.

Rule 5 Part II dealt with change of ownership of a business. In *Mills From Emelie Ltd v CIR* (1919) 12 TC 73 the main issue was whether a millinery business had changed ownership within the Rule. It was held on the facts that the taxpayer company was conducting a distinct business, although it had benefited from being given the order book on the retirement from a previous business of its sole proprietor.

Part III provided Rules for the ascertainment of capital. These Rules supported the provision in section 40(2) that the pre-war standard should, if it produced a higher figure than the actual pre-war profits, be a percentage on the capital of the trade or business as existing at the end of the last pre-war trade year.

Rule 1 provided for situations in which there was capital which did not consist of money, and it gave rise to several cases. Most of these concerned Rules 1(a) and (c), which dealt respectively with assets acquired by purchase and assets not acquired by purchase.

Sandwiched between them Rule 1(b) dealt with the different topic of debts, and that gave rise to one case. In *James Waldie & Sons Ltd v CIR* (1919) 12 TC 113 the company, coal merchants, successfully contended that certain loans comprised 'debts due to the trade or business' and therefore part of its capital within Rule 1(b). The loans had been made to rescue a struggling colliery company which was its main supplier and in which it had a controlling interest of just over 60%.

In *Bowden Brake Co Ltd v CIR* (1919) Leaflet No. 23 the company's claim that goodwill should be included in the computation of capital foundered on the fact that it had not acquired it by purchase and on the conclusion that growth of goodwill did not qualify as acquisition otherwise than by purchase within Rule 1(c).

Under Rule 1(c) the figure for assets which had been acquired other than by purchase was to be taken as the value of the assets at the time when they became assets of the business. In *Hamer v CIR* [1921] 1 KB 60 the appellant had expended £400 in acquiring a patent, but he contended that

subsequent trading results justified a value of £6,000 being placed on the patent. Rowlatt J, denying application of the gift of prophecy, upheld the decision of the Special Commissioners that £400 should be taken as the value.

In *Merlimau Rubber Estates Ltd v CIR* [1923] AC 283 the company had spent some £89,603 in improving a rubber estate which it had bought. The company's contention that the general meaning of capital applied failed because Rule 1 was held to be exhaustive. The contention that (c) applied failed because (a) applied and, while events might occur by which an asset originally within (a) might become an asset within (c), that was not shown on the facts of the case.

In *CIR v Huggins & Co Ltd* (1923) 3 ATC 136 the taxpayer company, brewers, had acquired licensed premises, either freehold or leasehold, and then leased, or sub-leased, them as tied houses, premiums forming part of the consideration. The company relied on Rule 1(a), but it was held that Rule 1 directed attention to the assets as at the last day of the pre-war trade year, 30 September 1913 in this instance, and at that date the company's assets were the freehold and leasehold reversions, assets which had not been acquired by purchase, with the result that (a) of Rule 1 was not in point but (c) was.

The Master of the Rolls made an interesting comment in relation to the balance sheet figure. He said 'We are also told how the company dealt with these assets in their balance sheet, but for the reasons which I stated in the argument and which I think it is much better to adhere to, neither the Crown nor the subject are finally bound by the balance sheet. It may well be the subject in his balance sheet has made some admissions or statement which may inure to his disadvantage against the Crown; on the other hand, he may not correctly have stated the true facts and the Revenue are not bound by it. I think it is much better to try and see what the actual facts are rather than to see how the company, when advised by their accountants, have presented these facts in the balance sheet'.

In *Sungei Rinching Rubber Co Ltd (in liquidation) v CIR* (1925) 4 ATC 430 the facts were similar to those in *Merlimau,* but differed sufficiently to produce the conclusion that by 31 December 1913, the end of the company's last pre-war trade year, the company's asset was not the original asset purchased. The Crown therefore failed in its primary contention that Rule 1(a) applied. The company's argument, viz that the market value on 31 December 1913 should be taken, also failed, the Crown succeeding with its alternative contention that Rule 1(c) directed use of the value of the assets at the time when they became assets of the trade or business, and on the facts that was October 1911 and not December 1913. The company sought a remitter to enable evidence to be given that the value of the asset in October 1911 was other than the figure used in the assessment, but that application was ruled out as too late.

Rule 2 Part II provided that the computation of capital was to exclude any capital the income of which was not to be taken into account for the purposes of Part I, and to exclude any borrowed money or debts. Several cases require mention.

In *Bolands Ltd v CIR* (1918) 4 ATC 526 Rule 2 was held to exclude Consols and other securities owned by the company deposited with a bank as security for an overdraft, and likewise perpetual debentures, as they constituted borrowed money.

In *Hollington Bros v CIR* (1920) Leaflet No. 56 advances to the appellant firm by its senior partner were held to be excluded by Rule 2.

In *CIR v Gas Lighting Improvement Co Ltd* (1923) 12 TC 503 the company owned shares in Belgian and Romanian companies which were in the same line of business. The case started out on the basis that the issue was whether the investments were not mere investments but comprised capital employed in the company's business. That had been the issue in both *Bourne & Hollingsworth Ltd v CIR* (1921) 12 TC 484 and *Lincoln Wagon and Engine Co Ltd v CIR* (1921) 12 TC 494, in which holdings of War Loan were held not to be capital employed in the company's business. In *Gas Lighting* it became clear that establishing that investments were not capital employed in the business did not alone achieve the desired result of boosting capital because Rule 2 might apply by reason of the provision in Rule 8 Part I that, subject to an exception inapplicable on the facts, no account was to be taken, in estimating profits, of income received from investments. Faced with this difficulty the company argued that Rule 8 applied only to investments made outside the conduct of the business, but that argument was rejected. In *Liberty & Co. Ltd. v CIR* (1924) 12 TC 630 the *Gas Lighting* decision was followed on facts similar to those in *Bourne & Hollingsworth*.

Rule 3 Part II provided that assets paid for otherwise than in cash should be taken in at a valuation at the time of acquisition. This Rule was held applicable in *CIR v Port of London Authority* [1923] AC 507, in which the Authority had acquired the property of three dock companies by the issue of some £22m of Port stock.

The *Bolands Ltd* case, referred to above, also involved a valuation issue about shares issued at par in 1888, the par value being preferred to a valuation which relied on dealings on the Stock Exchange a few months later at a substantial premium.

Sections 44 and 45 - Administration

Sections 44 and 45 comprised provisions about administrative matters such as returns, assessments, payment, and penalties. Several cases arose.

In *Smeeton v Attorney-General* (1919) 12 TC 166 the High Court declined to entertain a claim for a declaration. The plaintiff was an advisory

engineer who had provided services to a munitions company. He declined to complete EPD return forms on the grounds that his occupation fell within the exemptions in section 39(b) and (c). Peterson J refused to exercise his discretion to entertain the statement of claim on the grounds that the appropriate remedy was by way of appeal against an assessment in the normal way.

C Bushby & Sons v CIR (1931) 10 ATC 111 was a straightforward case of failure to file returns by a firm of public works contractors. Eventually the General Commissioners determined estimated assessments in reduced amounts but, on appeal, the Judge implemented an agreement between the parties for a remitter, subject to lodgment of security.

By section 45(2) 'the duty may be assessed on any person for the time being owning or carrying on the trade or business ...' Did 'for the time being' refer to the accounting period in respect of which an assessment was to be made or to the time at which the assessment was made? That question arose in *Wankie Colliery Co Ltd v CIR* [1922] 2 AC 51. Under a company reconstruction the company succeeded to a business which had made assessable profits in two accounting periods in 1914 when owned by the predecessor company which had been liquidated in 1915 before assessments came to be made. By a bare majority the House of Lords upheld the Crown's view that the words referred to the time at which the assessment was made. This was followed in *Boase Spinning Co Ltd (in liquidation) v CIR* 1926 SC 28, in which it was held that, in circumstances in which a business had been sold, section 45 (2) enabled the Revenue to assess the former proprietor for an accounting period of 23 days ending with the date of sale and for the previous full accounting period.

Amidst cases of which the lead name was *Tarn v Scanlan* (1928) 13 TC 91 was *W H Muller & Co (London) Ltd v CIR*. The appellant company was the shipping agent in London for the Batavier line, which was owned by two Dutch companies. The company sought to establish that it was the agent for the intermediary Dutch firm which had made the appointment and was not the agent of the Dutch shipping companies. On the facts this contention failed.

Section 45 (7) enabled regulations to be made to 'apply and adapt any enactments relating to the assessment and collection of income tax'. Regulations were made on 6 January 1916. One regulation empowered the making of estimated assessments, for which there were corresponding provisions in Income Tax law, and that regulation was held *intra vires* in *Inland Revenue v Morton (Whishaw) Ltd* (1921) 59 SLR 36.

But in *Gillette Safety Razor Ltd v CIR* [1920] 3 KB 358 the opposite fate met a regulation which purported to apply income tax provisions in section 31(2) which rendered assessable in the name of a UK resident profits made by a non-resident in circumstances in which the resident's

business profits were unduly low (or nil) because of a close connection between the two and of substantial control being exercised by the non-resident. It was held that the regulations could not enlarge the scope of EPD.

Amending Legislation – (1) Finance Act 1916

Section 47 of the 1916 Act was enacted to deal with loss of EPD in consequence of the sale of ships at wartime-inflated prices, but its opening words directed that its special provisions would apply 'if the Commissioners so require'. In *Northern Navigation Co Ltd v Inland Revenue* (1919) 56 SLR 171 the company appealed against a decision of the Revenue not to apply section 47, but the Court of Session held that the Revenue's discretion was absolute and was not challengeable by appeal.

Section 49 of the 1916 Act related to provisions as to director's fees. Under section 49(1) a company whose directors had a controlling interest might be treated by the Revenue as if it were a firm and as if the directors were partners. In *Glasgow Expanded Metal Co Ltd v CIR* (1923) 12 TC 573 it was held that the company's seven directors had a controlling interest in the company by virtue of their owning 4,300 of the 7,600 shares which carried a vote.

Under section 51 of the 1916 Act the accounting period directed by the articles of association was to be displaced where 'the books of a trade or business have been actually made up for any interim or other purpose in such a manner that the profits for that period can be readily ascertained'. This gave rise to two cases, each involving a cycle company. In *James Cycle Co Ltd v CIR* (1919) 12 TC 98 the company failed to establish that its first accounting period should be the twelve months to 31 May 1915 because, while it produced quarterly accounts, it took stock only once a year (31 August), so that it was impossible to ascertain each quarter's profits readily, or indeed at all with any approach to accuracy. In *John Marston Ltd v CIR* (1919) 12 TC 106 receipt of its first EPD assessment appears to have inspired the company to have its accounts reconstructed to 31 July 1913, 1914 and 1915, but Rowlatt J held that section 51 did not apply because it 'refers to the *de facto* past practice of the business or concern'.

Section 54 Finance Act 1916 enabled the deposit with the Revenue of money to be applied in satisfying subsequent liabilities to EPD, interest to accrue meanwhile at a rate to be described by the Treasury. In *Burns v Lord Advocate* (1924) Leaflet No. 97, the pursuer, who had used the facility in section 54, was held not to be entitled to interest on a repayment of EPD made to him following the decision in *Binney* (discussed above).

Amending Legislation – (2) Finance Act 1918

Under section 35(1) of the 1918 Act profits on sale, after 22 April 1918, of stock otherwise than in the course of trade, whether the trade was continuing or had ceased, were deemed to be profits arising from the trade or business. In *Neville Reid & Co Ltd v CIR* (1922) 12 TC 545 the issue was whether the date of the sale of the company's trading stock was, or was not, after 22 April 1918, and on the facts it was held to have occurred earlier in April.

In *Executrix of George Guest deceased v CIR* 1921 SC 440, it was held that section 35 applied to a case where a trader died and his legal representative did not carry on the business but simply sold the stock in trade for the purpose of realising and dividing the estate.

Amending Legislation – (3) Finance Act 1920

Section 45 Finance Act 1920 was a detailed amending provision with two functions. One was designed to make available a special pre-war standard for a trade or business which had no pre-war trade year. The other provided that, in the case of small businesses as defined, the percentage standard should be augmented by £500 in respect of each 'working proprietor', and the definition of those words included 'means a proprietor who has, during not less than one half of the accounting period, worked full time in the actual management or conduct of the trade or business.' In *Textile Materials Co v CIR* (1923) 2 ATC 313 the issue was whether the two partners of the appellant firm were working proprietors within the definition. One worked one whole day and one and half hours on the other days. The other spent two days a week and, beyond that, attended only when required. They were also involved in other businesses of similar character. Rowlatt J considered that they gave the businesses 'a certain amount of time which I should say was short of "full-time"'.

Amending Legislation – (4) Finance Act 1921

EPD was terminated by the 1921 Act, but section 39 confirmed that repayments and assessments might still be made. In *re Reade* [1927] IR 31 concerned assessments for each of the calendar years 1917–1920 raised on a Dublin poplin manufacturer by Revenue officials of the Irish Free State in 1923 in reliance on section 39. The applicant sought unsuccessfully to have a bankruptcy adjudication annulled on the grounds that the Government was not entitled to claim the duties in issue (the amount of which, some £7,758, was not itself in question). In the Supreme Court Kennedy CJ went into constitutional matters in some detail, but the other two judges

preferred to rest on the limited proposition that section 39 had been preserved by Article 73 of the Constitution of the Irish Free State.

Schedule 2 of the Act provided for relief in respect of the stock of a trade or business held at the conclusion of its final accounting period. In addition to *Fred W Millington (1920) Ltd v CIR*, mentioned earlier, there were three cases.

In *CIR v Millwards Merchandise Ltd* (1929) 8 ATC 6 it was held that the phrase 'realised sum' in Rules 3 and 4 did not refer to the gross proceeds of sale, but referred to the net proceeds, meaning the amount after deduction of the actual expenses of the realisation of specific articles sold, though without allowance for general over-heads or standing charges or anything of that kind.

In *Green & Co v Revenue Commissioners* [1927] IR 240 the appellants, grain merchants and importers, contended that each of several cargoes of grain were 'trading stock in hand' on 31 August 1921, with the result that losses on sales within the next two years should be reflected in the EPD computation for its final EPD accounting period. The Irish Supreme Court held that 'trading stock in hand' meant trading stock which was in the actual possession or under the control of the trader. In any event the Court was not satisfied on the facts that property in the cargoes of grain had transferred to the firm.

In *Benjamin Smith & Sons v CIR* (1926) 7 ATC 135 the same issue arose. The firm bought grain under CIF or ex-ship contracts, and sold mostly before, but sometimes after, the cargo had landed in the UK. The firm failed in a claim for relief on the basis that trading stock in hand on 31 August 1921 included all grain which they had contracted to buy up to that date, or which had been appropriated to them or shipped to their order up to that date. The decision of the House of Lords rather left it in the air precisely what the test was that the firm had failed. The Courts below were clear that trading stock in hand comprised only goods the property in which had passed unconditionally. Two of the Court of Appeal judges would have been inclined, if it had been necessary, to go further and agree with the Irish Judges in *Green* that, in addition to property passing, the goods must have passed into the actual control of the trader to have become trading stock in hand.

Amending Legislation – (5) Finance Act 1922

Section 34(4) provided for a charge of interest in respect of EPD paid late. In *Lord Advocate v John M Scott & Co Ltd (in liquidation)* 1927 SC 173 the company's liquidator failed in a contention that section 34(4) was limited to cases in which the Revenue had authorised payment of EPD by instalments under section 34(1). The liquidator's argument turned on the side-note to the section, but, in accordance with the general view at the time, the

side-note was given no weight. The conclusion was that the liquidator's argument could not be sustained against the wording of section 34(4) and later sub-sections.

Section 35 Finance Act 1922 extended section 45 (5) of the principal Act, so that an appeal would lie against the Revenue's determination 'of the amount of any deficiencies or losses in respect of which a person carrying on a trade or business is entitled to a repayment of or a set-off against excess profits duty....'.

In *R v Special Commissioners of Income Tax ex parte Peel Mills Ltd* (1925) Leaflet No. 121 the issue was whether the jurisdiction of the Special Commissioners extended beyond disputes about the actual amounts of deficiencies or losses to disputes about the taxation consequences which should follow from determination of the amounts. The company and the Revenue were in dispute about whether certain agreed deficiencies could be set against the whole of the profits for the six-month period ended 30 June 1920 or only against the proportion attributable to the part of that period in which the taxpayer company had owned the business. The Special Commissioners declined jurisdiction, but the Divisional Court disagreed and made an order of *mandamus*, holding that the words 'is entitled to' established a wider scope than the one which the Special Commissioners discerned.

Section 36 provided for repayments of EPD to be due where a business had changed hands under a 'voluntary disposition', as if it had not changed hands.

In *R A Bird & Co v CIR* (1924) 12 TC 785 a son had acquired his father's interest in a business of drysalters under an arrangement for takeover on the father's death. As that involved paying out the value of the father's share, it was held not to be a 'voluntary disposition'.

That case was followed in *CIR v A B and C G Clements* (1925) 4 ATC 417, in which the appellants acquired their father's business in consideration of payment to him of an annuity for his life of £500 per annum free of tax. The appellants' contention was that the value of the goodwill would have generated an annuity of £1500 per annum, and the real reason for the transfer was paternal affection. Rowlatt J rejected that contention. He accepted that nominal consideration would not prevent a disposition from being voluntary, but beyond that – and he described the consideration in the present case as 'a solid sum' – he thought it would be impossible to draw a line.

John Bartholomew & Son Ltd. v CIR 1926 SC 35 was another case in the same line. A business carried on by a firm of two partners was transferred to the appellant company in consideration of issue of shares in the company. The Court of Session held that the company could not set off its deficiencies against the firm's excess profits. Apart from section 36 that decision followed from *Gittus* (discussed above). As to section 36 it was held that the transfer

of the business could not be classified as a voluntary disposition. Further, a contention that set-off should be allowed to the shareholders was rejected because that would involve ignoring the separate *persona* of the company in order to treat the shareholders as the disponees.

Amending Legislation – (6) Finance Act 1926

Under section 38 of the 1926 Act 30 September 1926 was set as the last day for assessments and claims relating to EPD to be made, but by an exception either the taxpayer or the Revenue could designate a case as 'undetermined' and therefore outside that rule. Such a notice was not personal and could therefore found assessments made on personal representatives who had carried on the deceased's business after his death: *Weisberg's Executrices v. CIR*, mentioned earlier.

Under section 38(3) the Revenue were empowered to give a notice that all questions had been resolved so that an undetermined case had become determined. In *W H Cockerline & Co v CIR* (1930) 16 TC 1 the issue was whether such a notice had been correctly given. Sir Walter Cockerline, shipbroker and shipowner of Hull, and sole proprietor of the appellant firm, had been the subject of a back duty investigation involving EPD and other taxes. By agreement of May 1928 the underpaid tax was agreed, and the balance – there had been payments on account – was paid. Criminal proceedings were stopped by reason of Sir Walter's ill-health, but penalties of £300,000 were paid. The notice under section 38(3) was then, in December 1928, given. An appeal was made, apparently because a new adviser wished to raise fresh points regarding EPD. The taxpayer's main argument was that tax matters could not be settled otherwise than by an assessment process, but the Courts disagreed.

Other Litigation

EPD also figured in various Revenue cases involving interaction with other taxes.

Several cases involved the effects for Income Tax of a repayment of EPD. A repayment of excess EPD was held to be a profit for Income Tax purposes even if the company had ceased to trade and had gone into liquidation: *Kirke's Trustees v CIR* (1926) 11 TC 323, approving *Eglinton Silica Brick Co Ltd v Marrian* (1924) 9 TC 92 (itself followed in *Hill v Matthews* (1925) 10 TC 25 and the same result being reached in *A and W Nesbitt Ltd v Mitchell* (1926) 11 TC 211). In *Kirke's Trustees* it was made clear that a repayment of EPD was an assessable profit for the year of receipt, a conclusion applied by Rowlatt J in *Olive and Partington Ltd v Rose* (1929) 14 TC 701.

In *Tarrant v Roberts* (1930) 15 TC 754 it was held that, where a set-off of EPD liable to be repaid was made as against an unpaid EPD liability, the full repayment was made in accordance with the rule in *Spargo's case* 8 Ch App 407. Where two members of a partnership retired and the partnership was re-constituted by the remaining four, a repayment of EPD referable to an earlier period was held to belong to the members of the old partnership: *Rigden v CIR* (1935) 19 TC 542.

Three cases involved the interaction of EPD and the corporation profits tax introduced in 1920. In *Henry Lane & Co v CIR* (1924) 3 ATC 173 it was held that, where an accounting period straddled 1 January 1920, the deduction for EPD for the purpose of computing corporation profits tax was the proportion of the EPD liability for the whole period which was referable to that part of the period starting on 1 January 1920, and not 60% of the proportion of the profits referable to that part of the period (60% having replaced 40% as the rate of EPD from 1 January 1920). In his comment on this case, Mr Raymond Needham remarked 'The case affords an interesting example of the curious problems of construction which are incessantly presented by taxing Acts. Here the High Court Judge found that the view of the taxpayer was clearly right – "the present case is quite clear", and the Court of Appeal found that it was clearly wrong. It may be true that *les beaux esprits se recontrent*, but it is also true that they do not'. In *CIR v Stott & Sons Ltd* (1924) 3 ATC 440 the deduction for EPD in computing corporation profits tax for the company's accounting period from 1 April 1920 to 31 March 1921 was held to be £114, the overall EPD liability for the period, and not £43,897, which was the EPD liability for the first of its two half-yearly EPD accounting periods within the whole period, the company being entitled to a repayment of £43,783 in respect of a deficiency in the second of those two half-yearly periods. In *CIR v Anglo-Chilian Nitrate and Railway Co Ltd* (1925) 4 ATC 195 it was held that, where a carry forward of deficiencies franked profits made in a company's final EPD accounting period, so that no EPD was actually payable, the EPD which would, absent the deficiencies, have been payable was not deductible for corporation profits tax purposes.

EPD also figured in many cases which were not revenue cases. Three will be mentioned.

In *Thompson Bros & Co v Amis* (1917) 33 TLR 323, followed in *Collette v Lockie, Pemberton and Co* (1918) 145 LTJ 234, the plaintiffs, merchants and millers, relied on section 49(2) Finance Act 1916 as the basis of recovery from an employee of sums payable by them by way of EPD in respect of the employee's increased remuneration for various war periods as compared to the remuneration in the last pre-war trade year. By section 49(3) the right of recovery was limited to cases where the employee was a manager or person concerned in the management of the trade or business, and on the facts the claim succeeded.

Several cases related to employees' entitlement to commission by way of a percentage of the net profits of a business. In *Patent Castings Syndicate Ltd v Etherington* [1919] 2 Ch 254 the Court of Appeal held that EPD was deductible in ascertaining net profits, Warrington LJ noting section 35 and remarking that 'for income tax purposes excess profits duty is a deductible outgoing of the business entirely unlike income tax itself'.

Excess Mineral Rights Duty

It should also be mentioned that EPD was complemented, in section 43, by a distinct Excess Mineral Rights Duty, and that also gave rise to litigation.

In *Murray v CIR* [1918] AC 541 a lessor of collieries at rents or royalties varying with the prices of minerals when they exceeded a certain sum failed to establish that, as a matter of construction of section 43, he was not within the scope of the duty, and he also failed on a computational point.

Duke of Northumberland v CIR [1920] AC 825 concerned the treatment of income tax in computing the duty. The appellant contended that the calculation of the pre-war figures should reflect the then prevailing rate of income tax (1s 2d in the £), but the House of Lords held that Section 43 referred to the rate in the relevant accounting year (4s in the £).

In *CIR v Earl of Lonsdale's Trustees* [1919] 2 KB 183 the issue was whether, under section 43(2), the pre-war standard was to be calculated by reference to rental terms geared to a basis selling price of 6s 6d per ton set out in the original lease or to the adjusted figure of 7s 6d agreed between the parties on 14 April 1914. The Courts upheld the appellant trustees' contention that section 43(2) referred to the lower figure. Scrutton LJ, at page 199, said that the Crown's approach 'produces such a topsy-turvy result that you hit him if he does not profiteer and do not hit him if he does profiteer.'

CONCLUSION

Here ends this whirlwind tour of the case law (171 reported cases) relating to EPD. A rather more extensive version of this paper is well under way but is still incomplete. All being well, it will be available in 2004. Meanwhile here are a few overall comments.

A moderate amount of the EPD case-law has stood the test of time and is referred to even these days. The cases on what is a trade or an adventure in the nature of a trade remain seminal and feature in textbooks on Revenue Law. Likewise the decision in *Martin v CIR* about the scope of Schedule D Case VI, as mentioned in chapter 6 below David Stopforth's paper on *Government deliberations over taxing capital gains prior to 1962*. Much the

same applies to many of the cases on computation. This is, perhaps, more remarkable, because the practice in the days of EPD was not to introduce accountancy evidence but to leave ascertainment of ordinary commercial principles to the submissions of Counsel and to the judges in point of decision. All the same, the cases survive, and a recent example is the reference to the *Naval Colliery* case in the decision of the Court of Final Appeal of the Hong Kong Special Administrative Region in *CIR v Secan Ltd, CIR v Ranon Ltd* (2000) 74 TC 1,9.

Finally the anti-avoidance provisions, which outlawed transactions or operations which artificially reduced profits, appear to remain unique, and largely forgotten, in the canon of UK tax law, though, as Assaf Likhovski remarks in his paper, chapter 15 below, on *Formalism and Israeli anti-avoidance doctrines in the 1950s and 1960s*, they may well have influenced the content of Israeli tax law.

6

Deliberations Over Taxing Capital Gains – The Position Up to 1955

DAVID STOPFORTH

ABSTRACT

SERIOUS CONSIDERATION OF the introduction of a capital gains tax in the UK is usually thought of as beginning in the early 1950's when the Royal Commission on Taxation examined the issue. However, Treasury and Inland Revenue documents at the Public Records Office show that this is not the case as many Chancellors showed enthusiasm for the tax prior to this. The purpose of this paper is to review the official documents to try to explain why the UK was behind many developed countries in introducing this tax and to examine the arguments which were used both for and against it. In doing so, it provides an illustration of the nature of the relationship between the Chancellor, the Treasury and the Revenue. Perhaps surprisingly, it also shows the Revenue's strong resistance to this tax and their influential position in ensuring that it was not introduced until much later.

Introduction

Capital gains tax was only introduced in the UK in 1965 despite the fact that many industrialised countries had had some form of taxation of capital gains for many years. Pressure built up for its introduction following the publication of the minority views of the Royal Commission on the Taxation of Profits and Income which were strongly in favour of the introduction of the tax when they reported in June 1955.[1] However, the matter had been considered on numerous occasions prior to the publication of the minority report and this paper investigates those occasions. (A separate paper will review the position from 1955 onwards.)

[1] Cmd 9474.

The research for this paper is heavily based upon documents of the Treasury and Inland Revenue held at the Public Record Office (PRO). These documents give an insight into the negative attitude of the Inland Revenue towards the introduction of this tax and the motives of those politicians who had the ultimate power to force the matter through but always backed off.

The question of capital gains tax was barely considered at an official level prior to World War II and the problem at that time seemed to be how to tax what was described as 'casual profits'. As might be expected, the newly elected Labour Government of 1945 with its radical Chancellor (Hugh Dalton) was not long in getting round to consider whether a capital gains tax could be introduced. The Inland Revenue provided a report on 1 November 1946 which was so negative that it put off even this most radical of Chancellors. This paper was used repeatedly as each new Labour Chancellor of that first post-war Government came into office. Each took fright at what he was being told.

It might be thought that the first post-war Conservative Government (October 1951 to May 1955) would have taken no interest in a capital gains tax but surprisingly, this is not the case. However, their interest was minimal and the tax was never a real starter until adverse publicity about takeover bids in 1953 forced serious reconsideration of the matter. In the event, the Revenue were able to persuade the Chancellor yet again that capital gains tax was not the way forward and that a special tax on gains made from takeover bids would be impossibly complicated and not worth the effort.

Examination of the details of these events up to 1955 give an interesting insight into the relationship between the Inland Revenue, the Treasury and the Chancellor and the degree of influence the Revenue can have on the shape of the tax system.

Extending the Boundaries of Schedule DI

The evidence submitted by the Inland Revenue to the 1919 Royal Commission on the Income Tax[2] (the Colwyn Committee) made absolutely no suggestion that all capital profits should be made liable to tax. Despite the social reformer Sidney Webb pressing upon them the need to tax windfalls and capital gains, the Royal Commission was clearly only interested in the evidence provided by the Revenue, the Labour Party and the Federation of British Industry that profits made from speculation ought to be given special treatment.

The Revenue's evidence indicated that they often came across cases where large profits were made which did not arise in the carrying on of a trade,

[2] Cmd. 615.

profession or vocation. Where profits arose from an isolated transaction they were not, according to the case-law of the time, 'annual profits' and could not be charged to tax even though 'it may be apparent and may even be admitted that the transaction was entered into not as an investment, but for the purpose of seeking a profit by closing it with a sale'.[3] The Revenue wished to be able to charge tax 'on the many important transactions readily recognisable as business transactions even though they may be specific or solitary enterprises'.[4] However, the Board made it clear that it did not wish to have the sole power to determine which side of the line a case fell upon and suggested that a special body be set up to do so.

The Royal Commission was clearly impressed and was not satisfied with the existing narrow scope of the charge.

> We feel very strongly that at a time like the present, when taxation is necessarily high, to allow whole classes of sometimes highly profitable transactions to lie outside the range of the income tax, on the narrow technical ground that the resulting profits are not of a recurring character, should no longer be permitted, and ... the existence of this exemption is felt to be a real grievance by other taxpayers whose profits are taxed to the full.[5]

It therefore recommended that 'any profit made on a transaction recognisable as a business transaction, ie in which the subject matter was acquired with a view to profit seeking, should be brought within the scope of the income tax and should not be treated as an accretion of capital, simply because the transaction lies outside the range of the taxpayer's ordinary business, or because the opportunities of making such profits are not likely, in the nature of things, to occur regularly or at short intervals'.[6]

Having suggested that the scope of the tax should be so extended they went on to argue that it would be highly desirable to achieve uniformity of treatment and recommended that 'for the purpose of deciding principles and of obtaining uniformity in decisions, the Board of Referees [proposed in another part of the report] ... should be entrusted with the power of determining whether particular classes of transactions should be excluded ... .'[7] Any losses from speculation would only be set against subsequent speculative profits and not against other classes of income.[8] The Revenue estimated that the additional annual tax which would result from the proposals would be £200,000 per annum (approximately £44m in current terms).

Despite the considerable disquiet about these speculative profits escaping all taxation no specific legislative action was taken by the Government.

[3] Minutes of Evidence, para 25501.
[4] *Ibid*, para 25511.
[5] Report of the Royal Commission on Income Tax, Cmd 615 para 88.
[6] *Ibid*, para 91.
[7] *Ibid*, para 92.
[8] *Ibid*, para 94.

However, the Inland Revenue were already beginning to try to push the boundaries of Schedule D so that isolated profits could be brought within its scope where they arose from business-like transactions. The Revenue were extremely successful during the 1920s in overcoming some of the major difficulties they had had at the time of making their submission to the Royal Commission. In particular, 1923 saw a breakthrough when their success in *Ryall v Hoare* 8 TC 521 showed that the phrase 'annual profits' did not imply that they must recur year by year. Success in a series of later cases relating to isolated transactions considerably strengthened the Revenue's hand in assessing profits which had previously escaped all taxation on the basis that they fell outside the scope of Schedule D. This subject was revisited in 1955 by the Royal Commission on the Taxation of Profits and Income[9] when the majority rejected a capital gains tax but felt it necessary to reconsider the basis of the legal distinction between capital profits and revenue profits. However, the fundamental principle set out in 1920 in the Royal Commission's report that 'profits that arise from ordinary changes of investments should normally remain outside the scope of tax but they should nevertheless be charged if and when they constitute a regular source of profit'[10] remained virtually unquestioned until after the Second World War.

The Post-war Labour Government

When the possibility of introducing a capital gains tax was raised by the new Chancellor, Hugh Dalton, in August 1946, the Inland Revenue set up a small internal group to consider the matter and it reported to the Budget Committee on 1 November 1946.[11] In order to produce this report the Revenue had made a study of how the United States charged tax on capital gains and had been assisted by advice from the United States Treasury and the Internal Revenue Service. The report only ran to five pages but had a sizeable appendix detailing the American system and its history. The Revenue clearly had a very negative view of a tax on capital gains. As they explained each major principle of the United States system the Revenue pointed out practical or political problems in its application to the UK. For example, in the case of real property complexity would arise as there would have to be an allowance for enhancement expenditure, there would have to be valuations where only part of a property was sold and retrospective valuations would be needed for disposals of property held at the time the tax was introduced. For business assets, as no mention was made of rollover relief, the tax 'would certainly not help the re-equipment and modernisation

[9] Cmd. 9474.
[10] Cmd 615, para 90.
[11] PRO T171/391.

that is so essential for the development of British industry'.[12] For other forms of personal wealth such as furniture, jewellery, pictures, manuscripts, stamps etc. 'the taxation of such items ... would present appalling administrative troubles at any time, and simply could not be faced in the near future ... .'[13] Arguably, the Revenue were merely pointing out to their political masters the extreme complexity and difficulty in imposing a sophisticated and equitable capital gains tax. But they foresaw severe staffing problems too. As far as they were concerned, they were already not probing into accounts and examining business returns to a sufficiently high level.

> If we had the requisite strength of inspectors ... we could get more revenue by gathering in the full fruit of income tax than ever we would get by chasing capital gains.[14]

The only crumb of comfort offered was that it might be just practicable from the Revenue's point of view to tax short-term transactions in stocks and shares. However, this too was thought to be politically troublesome as it would be strongly opposed by the Stock Exchange, it would require brokers to give information regarding transactions and it would be criticised because it would leave other forms of capital gain untouched.

Other major issues covered by the Revenue's paper included the following:

- whether there ought to be graduated rates of tax and a differentiation between short-term gains and long-term gains as in the USA.
- the administrative need for an exemption for small gains.
- the territorial limits of the charge to tax. (The Revenue advised that it would be impracticable to enforce the tax on a non-resident who made gains on UK assets—the Americans had tried this approach and abandoned it).
- the base cost of assets acquired by gift or inheritance. (The Revenue suggested market value at the time of gift or of death).
- the need for 'elaborate legislation for obtaining information'.[15]
- the need for anti-avoidance provisions to protect against collusive arrangements especially between connected persons.

No estimates of the expected UK tax yield were provided but actual USA yields were set out and they showed the tax to produce a highly variable and unpredictable amount. In the last four years of the 1920s USA taxes on non corporate capital gains accounted for over 40% of all non corporate direct taxes whereas in the next eleven years from 1930 to 1940 inclusive,

[12] *Ibid*, para 8.
[13] *Ibid*, para 8.
[14] *Ibid*, para 11.
[15] *Ibid*, para 10.

the corresponding figure was less than 8%. The total tax on capital gains for those eleven years was well under half the total for the four boom years of the late 1920's. If this was not enough to put any Chancellor off, the Revenue provided an extract of an official report from the USA dealing with the case for repeal of the tax on capital gains. Its tone was very negative, as can be seen from the following example:

> No feature of the American income tax is subject to more complaint than the tax on capital gains and no part of the system of the tax has been so often and so radically changed.[16]

Given the presentation of these hard realities which would have to be faced by any Chancellor introducing a capital gains tax, it is not surprising that all the papers on this subject appear in the Treasury files under the heading 'Inland Revenue Proposals Not Proceeded With'. However, there is nothing on the PRO files to indicate any particular reason put forward by Dalton for not wishing to go ahead with the introduction of a capital gains tax. Some have argued that it was purely because of the Revenue's staffing difficulties.[17] The writer suggests that it was far more than a mere staffing issue and that once the practicalities of such a tax were considered, any Chancellor would try to find a different way of achieving his objectives.

Being committed to achieve a greater equality of incomes and property, Dalton had already increased surtax rates to compensate for the reduction he made in the standard rate of income tax and had also significantly increased estate duty, both of which had been done against the advice of his officials. At the time of his resignation, he was giving serious consideration to introducing a capital levy and passed on his ideas to his successor, Sir Stafford Cripps.[18] However, faced with considerable resistance to a capital levy from his officials, Cripps chose to impose an additional levy on investment income which was put forward to him by the Treasury as a more palatable alternative. This new charge was dubbed the 'special contribution' and was a graduated tax largely paid out of capital. It applied to all investment income above £250 where the individual's total income exceeded £2,000.

Although the Revenue may have thought that they had buried capital gains tax with the paper they put to Dalton, each successive Labour Chancellor resurrected it. Cripps was prompted to raise the issue when he read an article contrasting the treatment of capital gains in the UK with their treatment in the USA and many Western European countries.[19] The Chancellor had passed the article with a covering note minuting that

[16] *Ibid*, Appendix Part III.
[17] Whiting, R, *The Labour Party and Taxation*. Cambridge University Press, 2000, at page 89.
[18] Dalton, High Tide and After, 288–9.
[19] Precisely where this article was published is not known but it is described by a Treasury official as 'some review of International Trends in Income Taxation', PRO IR 63/184. 3 January 1950.

he was 'not clear that we can do nothing useful along these lines and I should like a scheme worked out and submitted before the next Budget'.[20] Treasury officials agreed that all that was necessary was to put the Revenue's original November 1946 paper to the Chancellor with a covering note updating some of the arguments. The covering memorandum emphasised that although capital gains tax was theoretically acceptable, it was quite impracticable to introduce it due to undermanning in the tax inspectorate and the difficulties faced in the Valuation Office in dealing with new work arising from the Town and Country Planning Act and the Rating Act. It was also emphasised that the tax had no merit as an immediate producer of revenue and might even produce an overall net loss due to diverting staff from more profitable work 'such as the important matter of proper liability under Schedule D'.[21] Furthermore, the Chancellor was advised that the legislation would be long, complex and so controversial that it would be fought bitterly not only in principle but in every detail. The Revenue's aversion to it was strong.

> In short, we feel that the question of the imposition of such a tax should be deferred until such time as the Revenue machine is in a position to assume the work involved without detriment to its other activities. Even then, the tax would have to be regarded as a luxury rather than as an important source of revenue.[22]

Given such persuasive arguments, Cripps backed off but in October 1950 Hugh Gaitskell became Chancellor and very soon capital gains tax was back on the agenda as a possible starter for the 1951 Budget. This was possibly prompted by the Attorney General who had, at his town instigation, passed the Chancellor a number of documents relating to the taxation of capital gains in the United States. The Revenue's response was to bring into service the November 1946 paper with a modified covering note reiterating the points made to the Chancellor's predecessor. However, by this time the recently appointed Royal Commission on the Taxation of Profits and Income had enquired whether its terms of reference were wide enough to cover the taxation of capital gains. The Revenue had little doubt that it would deal with this tax and pointed out to the Chancellor that 'it would hardly be possible to take action while the matter is under consideration by the Royal Commission'.[23]

A special meeting of the Budget Committee took place over the whole weekend 16–18 February 1951 and the Revenue's paper was fully discussed. The Chancellor accepted that the Revenue would have great administrative

[20] *Ibid.*
[21] PRO T171/400. Memorandum by the Board of the Inland Revenue 27 January 1950.
[22] *Ibid.*
[23] PRO T171/405, BC(51) 26, 8 February 1951.

difficulty with the tax but 'wondered whether it would be worthwhile looking again at some of the administrative objections, eg whether they could not dispense with some of the valuation which they were now doing'.[24] The Chancellor clearly felt suspicious of the advice he was being given and pointed out that the tax existed in America and that they must have experienced and overcome some of the difficulties which the Revenue referred to. Treasury officials (particularly Sir Eric Bamford and Arthur Cockfield) staunchly supported the Revenue's view pointing to the fundamental difference between the two tax systems, particularly regarding self-assessment. 'It was contrary to previous practice to impose a tax the yield on which depended on how much the taxpayer concerned wanted to offer'.[25] On the staffing point 'the Inland Revenue pool of trained staff was at present losing more than it was gaining as many of the chaps who had stayed on during the war were now getting old and were leaving and plans for replacing and training were only just beginning to fructify'.[26] Faced with such opposition, the Chancellor agreed that capital gains should not be examined any further but asked whether it might not be possible to bring forward a practical scheme for taxing short-term gains in stocks and shares.

Within two weeks the Revenue circulated an extremely negative review of such a short-term gains tax. They argued that transactions within a two-year period would be appropriate for the tax rather than the six months used in the USA and believed that it would have to apply to unquoted shares as well and even then it would still be attacked as being unfair if it did not extend to the real estate speculator. Further criticism could be levelled at the tax because of its failure to catch 'the particular kind of transaction which has attracted most attention recently, namely the public flotation of an old established private company [where] the amounts of money accruing to the original shareholders are often very large indeed'.[27] Such arguments, combined with a reminder that the yield of the tax would be highly volatile, the staffing costs to operate and police the tax would be high and the Royal Commission had earlier that month obtained a ruling that they could include consideration of taxes on capital gains, won a temporary reprieve for the Revenue.

A Cursory Review by the Conservatives

Once a Conservative Government came to power at the end of October 1951, the Revenue probably thought that their repeated need to resist capital gains tax would stop. However, in December 1951 the Chancellor made it known

[24] PRO T171/403. Minutes of Roffey Park Weekend.
[25] *Ibid*. Mr Cockfield.
[26] *Ibid*. Sir Eric Bamford.
[27] PRO T171/405 BC (51) 38. 2/2/51.

to the Revenue that the Prime Minister had spoken to him on the subject and requested them to provide a paper, which was to include references to the United States experience. The Revenue were by this time becoming very adept at producing the kind of response that would result in a rejection of capital gains tax and their paper of 14 December set out estimates of possible yield and the likely work burden. The tax was rejected as Ministers were not impressed by the expected yield in relation to the additional staff requirements.[28] However, the turn of events soon brought the matter back on the political agenda.

Takeover Bids Stimulate Further Interest

Controversy over the activities of takeover bidders, in particular the activities of Mr Clore in gaining control over Sears and Company Ltd, resulted in Treasury Ministers raising a formal internal enquiry in 1953 into whether it was proper or possible to restrain takeover bids on the grounds of public policy. The arguments for action were

- (i) that these activities damaged the Government's policy of voluntary dividend limitation as they encouraged directors to pay out much increased dividends to push up the share price to help protect the company from the bidders and themselves from redundancy;
- (ii) that a takeover which had the object of breaking up the business and distributing the capital was bad for the economy; and
- (iii) the spectacle of financiers manipulating the market and making big gains, reputed to be tax free, was a bad advertisement for the Stock Exchange and for free enterprise.

The Treasury concluded that takeover bidders were infringing neither the Companies Acts nor the rules of the Stock Exchange and that there were no grounds on which the Government could even express disapproval. The Treasury papers on the subject were transferred to the Revenue who were asked to 'keep a close watch on these operations so as to make sure that any gain that was liable to tax did not escape it'.[29] Senior officials at the Treasury and the Board of Trade were appointed to carry out a set enquiry into the whole issue and approached the Revenue for advice on what ought to be said in their report about action which could be taken under present taxing powers and what might be feasible if new powers were introduced. The Revenue were specifically asked whether the report could say that 'it must not be readily assumed that Mr Clore's gains are

[28] PRO IR40/16364, para 22.
[29] IR 63/199 at page 247.

capital and so tax free'.[30] As regards any new taxing powers the Treasury made it clear that 'the last thing we want to do is to provoke a revival of the capital gains discussion'.[31] The Revenue response made the position quite clear.

> ... there will not be much more than a one in a million chance of our being able to catch these birds. They are naturally astute, and it is a safe bet that they will do everything possible to defeat any attempt to bring the transactions in question within the tax net. Unfortunately it is not usually difficult for the bidders to arrange for the bids to be made by property-owning companies which have memoranda and articles of such a nature that any attempt to allege that they are trading, or carrying on an adventure or concern in the nature of trade, would be pretty well foredoomed to failure.[32]

As a result of the inability of the Revenue to tax such transactions under existing legislation, the whole question of capital gains tax was raised yet again and the Revenue submitted a detailed fifteen page paper to the Budget Committee on 1 January 1954.[33]

Almost two years earlier, the Revenue had submitted an even more detailed memorandum on capital gains tax to the Royal Commission on the Taxation of Profits and Income and so were well prepared.[34] The 1954 document concentrated on practical policy matters and the difficulties of implementation of the tax which had been raised in the original 1946 paper. However, the Revenue's knowledge of the subject was becoming more sophisticated each time they were asked to explain their views. Some Ministers may have thought that the Revenue were making an excessive fuss over the problems of introducing and administering such a tax in their earlier papers but in 1954 he Revenue were able to bolster their position by using a quotation from a book published in 1951 by the tax advisory staff of the United States Treasury whose opening paragraph read:

> Throughout the history of the income tax the provisions pertaining to capital gains and losses have been controversial and often misunderstood. The frequency with which these provisions have been changed suggest that a settled policy concerning the treatment of capital gains and losses as components of taxable income has not been established.[35]

With such independent evidence of the difficulty of taxing capital gains the Chancellor of the Exchequer quickly agreed that no further consideration be given to the subject.'[36]

[30] *Ibid*, page 248.
[31] *Ibid*.
[32] *Ibid*, page 249.
[33] PRO T171/439.
[34] Cmd. 9474, pp 425–470.
[35] T171/439, BC(54)1 at para 2.
[36] T171/449, Budget Meeting, 5 February 1954.

However, as a separate issue the Revenue had been considering whether it would be possible to recommend legislation designed to enable tax to be charged on gains arising solely from takeover transactions and submitted a paper to the Chancellor on 1 February 1954. The Revenue doubted whether the issue could be tackled fully and effectively without extending the scope of taxation to all corporate capital profits distributed to shareholders in a non-taxable form (either on liquidation or otherwise) or lent directly or indirectly to shareholders. Their view was that such legislation would raise the general issue of the taxation of capital gains over a much wider field and would be so highly controversial that Ministers would rule it out.

However, the Revenue went on to suggest a method of taxing 'the particular class of gains – technically of a capital nature – which are the object of takeover bids' but prefaced their scheme by commenting that 'there may be good takeover bids as well as bad ones; it all depends upon whether after the takeover the company's resources are put to better use than before, or are diverted to undesirable ends'.[37] They were very much in favour of a 'crackdown on operators who make these large tax-free gains if there were any simple way of picking them out from the field of capital gains in general; but we fear the remedy will be worse than the disease'.[38] Finally, they pointed out that the tax revenue raised would not justify the time that senior staff would have to spend on it. Looked at in the round they therefore suggested that no action was necessary at that time.

However, recognising that there were wider issues and that political or other considerations might make Ministers anxious to do something on the taxation of these gains, the Revenue set out their suggested approach to the problem. It involved an attack on the use of investment companies and one man companies to turn what were in substance business profits into tax-free capital gains. In effect, any participator in a close company would be assessed to tax if, looking at the transactions as a whole, and deeming them to have been carried out by him (rather than the company, or trustees of any related settlement) then they would amount to the carrying on of a trade of dealing in investments or other properties. The gains so made would be apportioned amongst the participators and assessed on them. The Revenue advised that an inevitable consequence would be that such legislation would apply to many transactions 'which are wholly free from the undesirable features of takeover bids ... but that it might ... go a long way to stopping speculative ... bids designed to secure a quick profit, without substantially affecting takeover bids where there is no intention of milking the company concerned of capital profits'.[39]

[37] *Ibid*, para 4.
[38] *Ibid*.
[39] *Ibid*, para 5.

A whole series of other difficulties were raised in the paper such as the extension of the legislation to non-UK companies, the treatment of losses, information powers, penalties, and powers to recover the tax from any individuals, companies or trustees concerned in the transaction. Furthermore, the Revenue's view was that if it was to be effective, the legislation would have to be so severe that its terms would be extremely controversial and 'even so, operators of the type now in question are so astute and elusive that we would not like to guarantee that the proposals will be completely effective'.[40]

Despite such extreme negativity, the Chancellor did not reject these proposals out of hand but asked that the Budget Committee review the matter and let him have a considered opinion.[41] The Economic Secretary to the Treasury was much more clear in his views.

> Legislation of the kind described would be a gruesome prospect. I do not think that at present we should even contemplate it.[42]

The Financial Secretary to the Treasury was also strongly against it and could see no reason or justification for such legislation. He thought it would be appallingly difficult and would 'take us quite a long way in the direction of the Opposition policy of taxation of capital gains'.[43]

On 11 February 1954 an Opposition motion deploring the technique of takeover bids in so far as they put large untaxed capital profits in the hands of certain individuals and seriously undermined the policy of dividend restraint was defeated. However, it stimulated over seventy columns of vigorous debate.[44] The Chancellor assured the House 'that the Inland Revenue are watching the position with that perspicacity, ability and knowledge which we all associate with their activities' and 'that this whole question [of taxation] is under the closest possible review'.[45]

The truth of the matter was that the Revenue were powerless. The Budget Committee met to consider the matter on 16 February 1954 and advised against taking any action that year but suggested the matter be left open for further review, indicating that such a delay would enable further useful information to be obtained as to the technique of operating takeover bids. The following day the Chancellor stated that he did not want the Revenue's ideas on this subject pursued. The matter fizzled out and it was not until work began on the 1960 Budget that it became a serious issue again.[46]

[40] *Ibid*, para 12.
[41] Handwritten note by R A Butler on the Revenue's paper,. 6 February 1954.
[42] PRO T171/439, 2 February 1954.
[43] *Ibid*.
[44] Hansard 11/2/54 cols. 1383–1458.
[45] *Ibid*, col. 1456 Mr Butler.
[46] PRO T171/506, Revenue Document M254, Sir Alexander Johnston to the Chancellor of the Exchequer.

CONCLUSION

In the period 1920 to 1955, the consideration of the taxation of capital profits, whether it was the taxation of casual profits in the 1920s or capital gains in later years, brings out the battle between the desire for social justice and the cost and practicality of introducing appropriate taxes. A constant theme is the Inland Revenue's resistance to the introduction of a capital gains tax whether long-term, short-term or on specific classes of transaction. It is absolutely clear that capital gains tax was a tax the Revenue just did not want. From a pragmatic point of view they could see too many difficulties in introducing and administering such a tax in the UK. The advantage the Revenue had in getting their way was their detailed knowledge of the nature of the USA tax on capital gains. This enabled them to put forward very persuasive arguments against its introduction here. The Treasury appeared never to have disagreed with the Revenue's views and its senior officials supported the Revenue line and knocked down any proposals for the tax in their briefing papers and in meetings with the Chancellor and other Ministers. However, the absence of taxation on capital gains created a perceived injustice which was returned to many times after the 1955 Royal Commission reported in 1955. These further developments will be returned to in a later article.

7

The Evolution of UK Tax Legislation for Employee Share Ownership Plans

PETER CASSON

ABSTRACT

THE PAPER EXAMINES the development of UK tax legislation to facilitate and promote the use of employee share ownership plans (ESOPs). It begins by tracing the evolution of the ESOP structure in the US, the development of a tax regime to facilitate its use in that country, and identifies the uses and abuses of ESOPs by US companies and their owners. The ESOP concept was transferred to the UK in the 1980s, the transfer requiring a financial system that would fund ESOPs, situations in which the ESOP concept could be applied and a structure consistent with the regulatory system that existed in the UK at that time. The paper shows that although all three conditions existed by the late 1980s, there was uncertainty about whether tax relief would be available to companies for their payments to ESOPs. A Conservative Government was lobbied to introduce legislation to remove this uncertainty and to provide other reliefs to facilitate, and promote, the use of ESOPs. Eventually the Government announced in 1989 that it proposed to introduce such legislation. The proposed legislation, which was drafted so as to prevent some of the abuses of ESOPs by US companies, received support in principle from the Labour and the Social and Liberal Democratic Parties. The main part of the paper examines the debate in the Committee Stage of the 1989 Finance Bill against the background of the views of the main political parties on employee share ownership and on the ownership of industry. As predicted during the debate, the statutory ESOP structure was not used because the legislation was too restrictive and failed to offer some of the features and reliefs that ESOP supporters had requested. Subsequent legislation relaxed some of the qualifying conditions and introduced additional reliefs. Eventually, statutory ESOPs were mainly used for a purpose that legislators had not foreseen in 1989.

1. INTRODUCTION

The then Chancellor, Nigel Lawson, announced in his 1989 Budget Statement that the Government would introduce legislation to provide companies with tax relief on their contributions to employee share ownership plans (ESOPs). The announcement was made after intense lobbying by supporters of the ESOP concept, and after amendments had been proposed by backbench Members to the 1986 and 1988 Finance Bills which, if accepted, would have provided such relief. This paper examines the evolution of the ESOP concept and the development of UK tax legislation, focussing on the Committee Stage debate of the 1989 Finance Bill.

The ESOP concept was developed in the United States, with the idea originally coming from Louise Kelso, a lawyer and investment banker. As originally conceived, this was for a company to set up a trust that would borrow funds to acquire shares for the benefit of employees, with interest and capital repayments being out of the company's pre-tax earnings. US legislation to facilitate and promote ESOPs came about through Kelso's association with the influential Democratic Senator, Russell Long. Initially Long introduced an amendment to the Employee Retirement Income Security Act of 1974 (ERISA). This was followed by approximately twenty-five pieces of legislation favourable to ESOPs. While the stated intention of the legislation was to promote employee share ownership, ESOPs were used by US companies for other purposes, including as a corporate financing technique and as an anti-takeover and a 'poison-pill' device.

ESOPs were frequently used in the US as a method of transferring ownership of often troubled companies to their employees. In the early 1980s, one such employee buy-out, that of a US airline, Frontier, came to the attention of Malcolm Hurlston. Hurlston, who was later to co-found the Employee Share Ownership Centre, took the concept to the newly formed trade-union Unity Trust Bank which was looking to identify areas in which it could become involved. Funding of ESOPs would be consistent with the bank's philosophy. In order for the ESOP concept to work in the UK it was necessary to devise a structure that would provide companies with relief on payments to ESOPs. Such a structure, referred to as a case-law ESOP, was devised by the law firm Clifford Chance. There were, however, problems with the case-law ESOP, not the least of which was uncertainty as to the deductibility of payments by companies to ESOPs. Such uncertainty was perceived to be inhibiting the use of ESOPs in the UK and so Government was lobbied to provide a statutory basis for deductions by companies.

ESOPs may be viewed as one of many types of employee share ownership scheme. Legislation already existed in the 1980s that provided tax preferences to encourage the implementation of employee share ownership schemes. This was through the all-employee profit-sharing scheme and the SAYE share option scheme. There had been a long history of profit-sharing schemes in the

UK, initially being associated with the co-partnership movement at the end of the nineteenth century. The value of co-partnership schemes[1] was recognised by the Liberal Party in the Report of its Industrial Enquiry (usually referred to as the 'Yellow Book'), published in 1928, and was to be a key element in the Lib-Lab pact in the late 1970s. It was as a consequence of its pact with the Liberal Party that a Labour Government, previously hostile to employee share ownership schemes, introduced legislation to provide tax preferences for profit-sharing schemes. A few years earlier, in 1973, a Conservative Government introduced legislation that provided tax preferences for approved SAYE share option schemes. The legislation, which was opposed by the then Labour Opposition, was repealed when the Party came back to office in 1974. Legislation on SAYE share option schemes was re-introduced in 1980, shortly after the Conservative Party came back to power. As well as announcing in his 1989 Budget Statement an intention to introduce legislation to provide companies with tax relief on their contributions to ESOPs, the Chancellor announced improvements to the two existing tax preferred employee share schemes.

The 1980s saw changes in the UK political landscape. First, the Conservative Party gave prominence to the concept of a property-owning democracy, sometimes referred to as 'popular capitalism', and also embarked on a major privatisation programme. Both elements are important to the Party's support of ESOPs. Employee share ownership was seen as addition to other methods of extending a property-owning democracy, such as the sale of council houses to their tenants and discounts on the floatation of shares in public corporations. The privatisation programme also incorporated employee and management/employee buy-outs, and the ESOP structure was useful in this context. Secondly, the Labour Party was moving away from its long held commitment to nationalisation and was considering other forms of social ownership. Its concept of social ownership in the late 1980s was quite wide, and specifically included ESOPs. Although ESOPs received support from both the Conservative Government and the Labour Opposition, the parties then held fundamentally different concepts of employee share ownership. Commitment to individual share ownership was central to the Conservative Party's support for ESOPs, whereas collective share ownership was at the heart of the support from the Labour Party. Finally, the Liberal Democratic Party, formed in 1988 by a merger of the Liberal Party and the Social Democratic Party (SDP), continued the Liberal Party's traditional support for employee share ownership.

By the late 1980s there was a financial infrastructure in place to support the development of ESOPs in the UK, a privatisation programme in which ESOPs

[1] Co-partnership schemes were a form of profit-sharing scheme in which employees received shares in the company instead of cash payments.

could be used, and a commitment to ESOPs from the Conservative, Labour, and Liberal and Social Democratic parties. The Government, however, was aware of the abuse of ESOPs by US companies and their owners, and so the legislation proposed in the 1989 Finance Bill only provided tax relief to companies under very restrictive conditions. Few companies as a consequence took advantage of the provisions of the legislation.

The remainder of the paper proceeds as follows. Section 2 examines the development of the ESOP concept in the US, and explores how ESOPs were used, and abused, by US companies and their owners. The transfer of the ESOP concept to the UK is described in section 3. This is followed by an examination of the evolution of legislation to provide reliefs for statutory ESOPs in section 4. The main themes identified in the paper are drawn together in the final section.

2. THE DEVELOPMENT AND USE OF ESOPs IN THE US

The concept of an ESOP was developed in the US, and subsequently imported into the UK. As discussed below, ESOPs in the US were structured within the context of a legislative framework which enabled companies to use, and sometimes abuse, the ESOP structure. Transfer of the ESOP concept to the UK required the development of a structure that provided tax relief on payments by companies to ESOPs. It also led to lobbying for tax legislation to remove uncertainties about the availability of tax relief. The success of ESOPs in the US was referred to in the debates on proposed legislation in the UK, as were some of the abuses by US companies and their owners. It was the abuse of ESOPs by US companies that was to shape at least a part of legislation proposed by the UK Government in 1989.

Louis Kelso is generally credited with devising the ESOP structure. The rationale for ESOPs, at least as far as Kelso was concerned, is to be found in his economic philosophy. Kelso, who was a successful lawyer and investment banker, developed an alternative economic philosophy, referred to as binary economics. He and his various co-authors argued that with the advance of technology capital becomes increasingly more important than physical labour, as capital contributes progressively more than physical labour to production. If the distribution of income is determined by market forces then the owners of capital will become richer at the same time as the providers of labour find it more difficult to survive. As a consequence, a mismatch will occur between production and individuals' financial ability to consume, leading to an economic crisis. Governments had previously responded to such crises by using redistributive policies, including creating public employment and supporting trade union pay demands, to increase the income of those without capital. Kelso's solution to the problem was to spread the ownership of capital so that, as technology replaced labour,

individuals previously dependent solely on labour income would have additional income from capital assets.

Kelso and his associates rejected redistributive measures of achieving wider capital ownership. Rather they proposed that individuals with little or no capital could acquire shares in companies using funds borrowed from banks and other financial institutions, and use income from the shares to repay the loans. In order to make this work, Government would support these individuals, referred to as *financed capitalists*, by insuring the loans and allowing companies to make distributions out of pre-tax profits to financial capitalists. The idea of using credit to create financial capitalists was the basis for leveraged ESOPs. Kelso first put the idea into practice with an employee buy-out of Peninsula Newspapers of Palo Alto, California. Here, Kelso established an employee benefit trust which purchased the company's shares using loan finance. Interest and principal on the loan were paid out of the company's earnings within eight and a half years, although the loan had a term of fifteen years.

Legislation to facilitate and promote the use of ESOPs came about through the association between Kelso and Russell Long, the Democratic Senator for Louisiana and son of the assassinated Senator Huey Long. At the time of his meeting with Kelso, Russell Long had been Chairman of the Committee on Finance for sixteen years and Senior Democratic Senator for five years. Unlike his father, who had advocated redistributive methods, Russell Long believed in giving workers a stake in an expanding wealth base, suggesting that the Government should see that '. . . . every working American has an opportunity to become a capitalist'. Following an attempt to promote the use of ESOPs in restructuring two failing railway companies, which came to nothing, Long proposed an amendment to the Employee Retirement Income Security Act of 1974 (ERISA). This now forms the central element of US legislation on ESOPs. Unlike other defined contribution plans, the Act required ESOPs to invest in the shares of the sponsoring company, and allowed them to borrow in order to purchase the shares. This was the first of approximately twenty-five pieces of legislation favourable to ESOPs that Long processed through Congress.

There were different types of ESOP structure. Blasi[2] identified three basic types: the non-leveraged ESOP, the leveraged ESOP and the tax credit ESOP. In the non-leveraged ESOP, a company made a tax deductible contribution to a trust for the acquisition of its shares. This structure did not conform to the aim of increased employee ownership using loans to be paid off by profits generated by the company. The leveraged ESOP best reflected the economic philosophy of Kelso in that it involved the use of loan finance that was repaid out of the company's earnings. Legislation to create the third type of ESOP, the tax credit ESOP or TRAOP, was also introduced by Long. It gave

[2] Joseph Blasi (1987) *Employee Ownership: Revolution or Ripoff*. New York: HarperCollins.

companies an investment tax credit of two percent in addition to the normal credit of ten per cent. This legislation was abolished in 1986.

Although changing through time, legislation favourable to leveraged ESOPs covered all parties of the ESOP structure. First, shares accumulated untaxed within the trust and employees were not taxed until the shares were received. Secondly, the sponsoring company was allowed a tax deduction for both interest and principal payments to the trust. In addition, the sponsoring company was allowed a deduction for dividends paid to the ESOP. Thirdly, rollover relief was available to the seller of shares in an unlisted company where the transfer was of at least thirty percent of the company's share capital. Finally, for the period from 1984 to 1996, a lender who was a bank or other type of approved financial institution, was allowed to exclude from taxable income one-half the interest earned from loans to ESOPs.

The number of ESOPs, and the number of employees covered by them, increased significantly following the enactment of the legislation. The National Center for Employee Ownership estimated that in 1978 there were 4,028 plans covering 2.8 million, growing to 9,500 plans covering 9.5 million employees a decade later. This meant that by 1988 more than ten percent of the US labour force was covered by ESOPs. Scholes and Wolfson[3] suggested possible reasons for the increase in the number of plans were: (1) to take advantage of the tax benefits that were not available to other ways of compensating employees; (2) to provide employees with work incentives and retirement benefits; and (3) as corporate financing device. Scholes and Wolfson conclude that the case for the growth in ESOPs being motivated by taxation was very weak as there are other ways of obtaining the tax advantages.

The argument that ESOPs provide incentives to employees has been the subject of many studies. In the context of the present paper, the most important of these was by the US General Accounting Office (GAO) which reported that the incentive effects of ESOPs, as reflected through greater firm productivity, were not present. It is in the third area that the use of ESOPs was perhaps most significant.

There were several corporate finance objectives which could be achieved through use of leveraged-ESOPs. The first was as a way of achieving an employee buy-out of a company, or part of a company, often one in financial difficulties. Many of the oft-quoted examples of the benefits of ESOPs related to such buy-outs. Secondly, ESOPs could be used as a anti-takeover devise, or 'poison-pill'. Thirdly, ESOPs could be used to provide a 'market' for shares in unquoted companies. Finally, ESOPs could be used by family companies to transfer ownership of the company while retaining control.

[3] Myron S. Scholes and Mark A. Wolfson (1989) *Employee Stock Ownership Plans and Corporate Restructuring: Myths and Realities*. Working Paper No. 3094, National Bureau of Economic Research.

The opening sentence of Rosen's paper on ESOPs[4] is: 'In Weirton, West Virginia, 8,200 capitalists go to work every day in the steel mill they own'. The use of an ESOP in the employee buy-out of Weirton Steel was often cited in support of the benefits of ESOPs. The background to the buy-out illustrates some of the dimensions to employee buy-outs that were to be found in other cases. Weirton Steel was a troubled division of the National Intergroup Inc., formerly the National Steel Corporation. The choice for the workers was an employee buy-out or the company being shut down. The ESOP acquired the assets of the company for US$194.2 million in 1984, and took on an equivalent amount in debt. The workforce agreed to a large number of redundancies and a pay-cut of approximately 20 per cent. The financial performance of the company has varied over the years. In 1989 and 1994 the company raised equity funds from the market and by 1994 Weirton Steel was 75 per cent publically owned.

ESOPs have been used as an anti-takeover defence. A large block of shares would be placed in the hands of employees through an ESOP, and in certain cases this served to block takeovers. Under a Deleware law passed in 1987, bidders for a company who own more than 15 per cent of the company's shares were required to wait three years before taking control of the company unless they acquired at least 85 per cent of the shares or obtained the approval of two thirds of shareholders, other than the bidders, or the board of directors and shareholders exempt the company from the provisions. The first large company to take advantage of these provisions was the Polaroid Corporation who was threatened with a hostile takeover by Shamrock Holdings Inc. Polaroid established an ESOP, with the approval of the Court, which was effectively used to block the takeover. More generally, Beatty[5] shows that there was a fall in a companies' share prices when companies subject to a takeover attempt announced that they have established an ESOP.

The use of ESOPs to provide a market for a company's shares was important in situations in which the shares were not listed. The ESOP structure provided for shares to be purchased from employees leaving a company's employment. Finally, ESOPs could be used to transfer shares in a closely held company when the owners wished to exit. This was particularly important where there was a retirement of a manager who held a large portion of the company's shares. ESOPs therefore had a role in succession planning for family companies. The rollover relief available on certain transfers was crucial to this type of transaction. One problem was that there may have been a transfer of ownership to employees without the transfer of control.

[4] Corey Rosen (1991) *Employee Ownership: Performance, prospects and promise.* In Corey Rosen and Karen M. Young (Edts.) *Understanding Employee Ownership*. Ithaca, NY: ILR Press.

[5] Anne Beatty (1995) The cash flow and informational effects of employee stock ownership plans. *Journal of Financial Economics*, 38, 211–240.

Employees were therefore bearing the risks of the investment without having control rights.

ESOPs are therefore both a method of fulfilling the economic aims of Kelso's philosophy and a technique of corporate finance. It should be remembered that Kelso was not only an economic philosopher, he was also an investment banker. In this role, Kelso and his firm were significant players in the market for providing consultancy on ESOPs.

3. THE TRANSFER OF ESOPs TO THE UK

Malcolm Hurlston, later to co-found and become chairman of the Employee Share Ownership Centre, is credited with transferring the ESOP concept to the UK. His interest followed newspaper reports that the employees of Frontier intended to acquire the US airline, and his discovering that an ESOP was being used as the vehicle for the purchase. At the time, Hurlston was acting as an adviser to the Co-operative Bank, one of the sponsors of the Unity Trust Bank. Hurlston contacted Terry Thomas (now Lord Thomas of Macclesfield), then managing director of the newly formed Unity Trust Bank, suggesting that the ESOP concept was consistent with the Bank's mission. Unity Trust Bank had been established in 1984 'by trade unions for trade unions'. Unity Trust Bank was later to play an important role financing ESOPs, and its work in this respect is referred to on several occasions during Parliamentary debate.

US ESOPs benefited from the favourable tax breaks provided under the Internal Revenue Code. In order for UK companies to establish ESOPs it was necessary to devise a structure which provided for tax relief on payments to ESOPs. David Reid, a partner in the law firm Clifford Chance, devised such a structure based on case law and approved profit-sharing schemes in 1986. A year later, the ESOP structure was to be used for the first time in the UK by the motorway services company Roadchef. Here the ESOP initially acquired a 12.25 per cent stake, partly from a new issue of shares and the remainder from family owners. Over the following three years the ESOP acquired further shares so that at the end of this period it owned about one third of the company.

Although case-law ESOPs were used by other companies in the late 1980s, the growth in their use was slow compared with that found in the US. Ian Taylor[6] identified three main barriers to ESOPs in the UK. First, establishing common law ESOPs which would provide companies with tax relief on their payments required the use of two separate trusts – an Employee Benefit Trust (EBT) and a Profit Sharing Trust (PST). This structure was suggested as being cumbersome, and different from US practice where tax relief was available

[6] Ian Taylor *Fair shares for all the workers*, London: Adam Smith Institute 1988.

when only a single trust was used. Second, there was confusion over the tax treatment of a companies' contributions to EBTs as there was no statutory basis for the deduction, and no clearance procedure. This meant that companies making contributions to ETBs faced uncertainty over the deductibility of these payments, so providing a disincentive to establish ESOPs. Finally, a capital gains tax liability could arise on owners wishing to transfer companies to an ESOP.[7] This contrasted with the roll-over relief available to owners selling to another company in exchange for shares. In addition to tax disincentives to establishing ESOPs, Taylor highlighted restrictions in company law preventing public companies giving financial assistance for the purchase of their shares. This prevented companies providing guarantees for ESOP borrowing. Increased use of ESOPs therefore depended on new legislation.

4. THE DEVELOPMENT OF STATUTORY ESOPs

Increase in the use of ESOPs by UK companies was seen to depend on the introduction of legislation that would at least ensure the deductibility of payments to ESOPs, and ideally would provide reliefs to owners transferring shares to ESOPs. By the late 1980s there was support for legislation on ESOPs coming from the Conservative, Labour, and Liberal and Social Democratic parties. Such support derived in part from their views on employee share ownership in general, and on ESOPs in particular. These views, especially those of the Labour Party, were to change significantly over time. The debate on proposals for legislation to facilitate the use of ESOPs can be seen in the context of the parties' views on employee share ownership and on the ownership of industry.

UK Political Parties, Employee Share Ownership and ESOPs

Support for legislation on ESOPs came from the Conservative, Labour and Liberal Democratic parties. Despite the apparent consensus between the parties, there were fundamental differences between the Conservative and Labour parties about employee share ownership in general, and ESOPs in particular. However, the degree of consensus between the parties would have been unlikely to have come about had the legislation been proposed a decade earlier. The 1980s saw fundamental shifts in the Conservative and Labour parties, as well as a merger in 1988 between the Liberal and Social Democratic parties to form the Social and Liberal Democratic Party (SLD), renamed the Liberal Democratic Party the following year.

[7] Taylor also pointed to the possibility of inheritance tax arising on the gifting, or sale below fair value, to employees when the transfer was other than of a majority stake in the company.

Conservative Party

There were two main strands to the Conservative Party's support for ESOPs in the late 1980s. The first was the Party's commitment to a property-owning democracy; the other was its privatisation programme. The former also formed an important element in the Party's promotion of employee share ownership schemes more generally.

Conservative Party support for employee share ownership derives from the Party's long standing commitment to a property-owning democracy. Private property was seen as essential for the development of individuality; character and ownership being viewed as developing alongside one another. Private property was also seen as the basis of civilisation. Common ownership, associated with socialism, was considered to have no effect on the individual as what is owned in common is owned by no one. Conservative policy was therefore to preserve, and extend, private ownership.

In the early part of the last century Conservatives saw co-partnership schemes as the method of extending the ownership of private property. Not only was co-partnership viewed as a method by which workers could acquire a share of companies' capital, it was seen as a way of identifying the interests of workers with those of the owners of capital.[8] An expression of similar ideas can be seen in Committee Stage of the Finance Bill 1978 debate on profit-sharing schemes when John MacGregor (Conservative) stated that '... employee share ownership reinforces four important Conservative objectives: (a) a steady move towards a more deeply-rooted form of individual capital ownership on a wide scale, with a chance to unwind excessive collective ownership; (b) a conscious attempt to soften industrial conflict at the workplace, and, more widely, to inculcate in all sections of the community a renewed sense of purpose; (c) an emphasis on profitable industry as the engine of the nation's wealth; and (d) for the individual worker, an opportunity to achieve a real measure of economic independence'.[9]

Another strand of traditional Conservative Party policy had its roots in the writings of Edmund Burke. Here there was the expression of respect for constitutional tradition, and a belief in evolutionary and organic change. This can be seen in the position on industrial policy where the Conservative response to Labour Party's nationalisation programme in the late 1940s and 1950s was to promise to '... restore free enterprise where that is practicable', rather than commit a Conservative Government to a programme of denationalisation. The post-war period was consequently characterised by the acceptance of a 'mixed economy'. This was to change radically with

[8] Rockow, L. (1927) The political ideas of contemporary Tory democracy. *The American Political Science Review*, 21, 1, 12–31.
[9] Standing Committee A, 15 June 1978 col. 1223.

the election in 1979 of a Conservative Government committed to popular capitalism and privatisation.

The privatisation programme of the Conservative Government was interlinked with its promotion of popular capitalism. Before the 1979 election approximately 9 per cent of the adult population in the UK owned shares in companies. This was to rise to about one in four of the adult population over the following decade. Part of the privatisation programme took the form of the sale of shares to the public on favourable terms when previously public corporations were listed on the Stock Exchange. Another part of the privatisation programme involved the disposal of parts of the public sector to their managers and/or employees as management and/or employee buy-outs. The ESOP structure was ideally suited to these employee buy-outs.

Labour Party

The Labour Party's stance on ESOPs and employee share ownership has to be considered against its position on the ownership of industry. Until 1995, the Labour Party's basic position on the ownership of industry was contained in Clause IV, Part 4, of the Party's constitution. This referred to the '... common ownership of the means of production'. Introduced in 1918, the wording of the clause was intended to leave open the precise form of 'common ownership', which could range from workers' cooperatives to nationalised industries. Its wording was designed to appeal to both the Guild Socialists, who favoured ownership by workers, and Fabian Socialists who sought public ownership and control of industry.

The opportunity for implementing Clause IV came with the election of a Labour Government, led by Clement Atlee, in 1945. This Government implemented a form of nationalisation of industry based on a public corporation whose managers were accountable to a Secretary of State. Professional managers were responsible for running the corporation and workers' interests taken into account through the same sort of trade union arrangements as existed in the private sector. Clause IV was a central component of the Labour Party's constitution and was not challenged openly until the late 1950s. There was, however, a school of revisionist socialism that developed after the fall of the Atlee Government in 1951 which disputed the principle that socialism was identified with public ownership. Hugh Gaitskell, who was both Party Leader and a revisionist, was defeated in his proposal at the 1959 Party Conference to change Clause IV to incorporate the principles of a mixed market economy.

Changes in the Party's attitude to employee share ownership were linked to its position on Clause IV. However, as the Labour Party incorporated a diverse range of political views, there was unlikely to be a consensus within the Party at any time. Legislation which would have granted tax

preferences for SAYE share option schemes was proposed by a Conservative Government in 1973. The impetus for this legislation partly came as the response to criticism by Labour members about the introduction of a favourable tax regime for executive share option schemes. At the Committee stage of the 1972 Finance Bill, Labour members had argued that, on grounds of equity, favourable tax rules should be extended to schemes involving the majority of the workforce. A year later there was considerable opposition to the proposed legislation on SAYE share option schemes. At that time, Labour members expressed the views contained within the Party's Green Paper *Capital & Equity.*[10] The Green Paper, which addressed problems of inequality in the distribution of wealth, rejected the proposed legislation on SAYE share option schemes as they would lead to new inequalities. Instead there was a proposal for a 'National Workers Fund' based upon the Danish Capital Sharing Plan. As proposed for the UK, companies would be required to transfer, annually, a proportion of their equity to a Fund, usually by the issue of new shares. The Fund would be run by a Governing Council, with workers nominated by the TUC, in the majority. Workers would have a claim on the Fund that could be cashed in after a period, or at retirement. Although provisions for SAYE share option schemes came into law in the Finance Act 1973, the legislation was repealed following the election of a Labour Government in 1974. Only four years later, as a part of its agreement with the Liberal Party, a Labour Government was obliged to introduce legislation to provide tax incentives for profit-sharing schemes.

Another relevant strand of the debate in the early 1970s related to industrial democracy, as opposed to ownership of industry. In 1974 the Trades Union Congress (TUC) published a paper *Industrial Democracy*[11] which rejected co-partnership and profit-sharing schemes because they did not allow control, imposed additional risks on workers, and led to new inequalities. Instead the report favoured the system of two-tier boards, with the appointment of worker representatives to supervisory boards. The proposals led to the appointment, by the Labour Government, of a Committee of Inquiry on Industrial Democracy, under the chairmanship of Lord Bullock, that reported in 1977. The majority report favoured a unitary, rather than two-tier, board structure with employee directors. The proposals were taken forward in a White Paper the following year but were lost with a change in government.

Following its defeat in the 1983 election, the Labour Party started to move gradually away from advocacy of large-scale public ownership. For at least a part of the Party, the goal of nationalisation was being replaced by a programme of social ownership. Ideas of social ownership were seen

[10] Opposition Green Paper *Capital and Equality: Report of a Labour Party Study Group*. London: The Labour Party 1973.
[11] Trades Union Congress (1974) *Industrial Democracy*. London: TUC.

to include the concepts of workers' cooperatives, municipal enterprises, more effective regulation, improved consumer protection and workers' share ownership schemes. ESOPs, in particular, were seen to have an important role to play. Bryan Gould, then Shadow Trade and Industry Secretary and a leading advocate of the principle that social ownership, suggested that employee share ownership schemes could be extended across the private sector of the economy. Questioning whether this is a truly socialist goal, he wrote in 1988 that: 'There will be those who claim that only state ownership meets socialist requirements .... Quite apart from the idea's long socialist history, it is surely undeniable .... that employee share ownership does address one of the main concerns - that workers are excluded from a share in the capital wealth created by enterprises for which they work'.[12] The form of employee share ownership favoured by Gould was the ESOP.

The commitment of important sectors of the Labour Party to social ownership represents one main strand in its support for legislation to facilitate the use of ESOPs. Another strand comes from the privatisation programme of the Conservative Government. In particular, the privatisation of municipally owned bus companies was the subject of the first large wave of ESOPs in the UK. The un-winding of industries nationalised in the post-War period was, in the late 1980s, thought to lead to other ESOPs. In addition, Unity Trust Bank, a bank established by the trade union movement, had already played an important role in the development of ESOPs in the UK.

Liberal Party

Liberal and Social Democratic Party support for legislation to facilitate the use of ESOPs derives from the Liberal Party's commitment to employee share ownership. This commitment follows from the report of the Liberal Industrial Enquiry, *Britain's Industrial Future* (usually referred to as the Yellow Book), published in 1928.[13] Work by the Liberal Industrial Enquiry, which was financed by Lloyd George and organised by an executive committee selected by the Liberal Summer School, had started in 1926. The purpose of the enquiry was to examine the problems of British industry and make proposals. Liberal philosophy underlying the recommendations of the report was that democracy had been established: '... in order that the people may have the means of remedying grievances, of creating the conditions that are necessary for their welfare, of securing that no member of the community shall be denied the opportunity to live a full and free life'. (p. xvii).

[12] *Financial Times*, 6 January 1988.
[13] Liberal Party (1928) *Britain's Industrial Future: being the Report of the Liberal Industrial Inquiry*. London: Ernest Benn.

The executive committee divided the research into a number of topics, each of which was the responsibility of a separate sub-committee. It was the report of the sub-committee on Industrial Relations, contained in Book 3 of *Britain's Industrial Future*, that dealt with employee share ownership. Arguments for employee share ownership fell into two categories: one relating to the benefits of profit-sharing and the other to the need for a wider distribution of share ownership. On profit-sharing, the Report suggested that: 'It is essential for the success of profit-sharing that it should be generally realised that its primary object is not to bring about an increase of output per head, nor to increase directly the workers' remuneration ..., but to improve industrial relations by making it clear that the product of industry is divided on known and established principles, and thus to facilitate co-operation in the pursuit of efficiency' (p. 200). Two basic forms of profit-sharing were identified in the report. The first, which was referred to as 'profit-sharing proper', involved a cash distribution; whereas the other form, 'co-partnership', retained the profits within the company and distributed shares to employees. It was this second form of profit-sharing that was favoured in the Report.

Co-partnership was favoured because of its role in correcting what was perceived as the mal-distribution of property ownership, and the ownership of shares in particular. The Liberal solution, encouragement of 'popular ownership' to facilitate the wider diffusion of property ownership, was contrasted in the report with socialist views that more equitable distribution could be achieved through public ownership, in particular concentration in the hands of the State. Ownership of private property was seen to be a safeguard to personal liberty, as important to individual self respect and as something that teaches responsibility. Profit-sharing schemes involving the distribution of shares were suggested as having two advantages over those that involve cash: first they facilitated the creation of new capital; and second, they contributed to bringing about the wider diffusion of share ownership.

The findings and recommendations contained in the Report were, following discussion as regional and national conferences, adopted as the official policy of the Liberal Party. Subsequent Liberal Party documents made reference to employee share ownership and profit-sharing. For example, a 1968 report *Partners at Work* suggested that employees be given a stake in company capital and profits in order '... to promote social justice, spread wealth more fairy and enhance the sense of common interest between employees at all levels, and those who contribute their savings to a company in the form of outside capital'. No particular form of profit-sharing arrangement was being promoted. A pamphlet, *Democracy at Work*, published in 1976 follows the recommendations of the Yellow Book in proposing that profit-sharing could involve cash payments, or share distributions or a mixture of the two. The writers of the pamphlet also described

an arrangement that seems similar to an un-leveraged ESOP under which a company could finance a fund out of profits which would invest in the company itself, or elsewhere.

Half a century after the publication of the Yellow Book, the policy on profit-sharing was to become a key element of the so-called Lib-Lab pact, an agreement under which the Liberal Party agreed to maintain a Labour Government in power. In an exchange of letters between the leaders of the two parties,[14] the Government agreed to consider ways of encouraging profit-sharing schemes. A few months later it was announced in the Queen's Speech that the Government would hold consultations about encouraging profit-sharing through the tax system.[15] The Inland Revenue issued a consultative paper in the following February, and in April Denis Healey, the Chancellor, announced proposals to encourage profit-sharing which he said would '... encourage employees to identify themselves more with their company'. It was, however, a Liberal Party MP, John Pardoe, that was the force behind the proposals. In the Committee Stage of the Bill, Pardoe emphasised the importance of the Yellow Book in defining the purpose of profit-sharing. He did, however, go somewhat further by indicating that he saw '... these profit-sharing schemes as a tiny step forward in the direction of a new economic order'. The vision of a new economic order was an alternative to both capitalism and socialism.

Early Attempts to Introduce Legislation

There were two attempts to introduce legislation favourable to ESOPs before the Finance Act 1989. The first of these was in 1986 when Nigel Forman (Conservative) introduced a new clause to the Finance Bill. The other was the introduction of new clauses into the 1988 Finance (No. 2) Bill by Ian Taylor (Conservative) and by Andrew Hunter (Conservative). Hunter withdrew his new clause during the Committee Stage of the Bill as it was similar to the one proposed by Taylor.

Finance Bill 1986

The clause introduced by Nigel Forman into the 1986 Finance Bill was drafted on the basis of advice given by Job Ownership Ltd and a law firm, Field, Fisher and Martineau. The provisions of the new clause, it was suggested, were a logical extension of the policy of encouraging wider capital ownership. In addition, a number of benefits were suggested to flow from the new clause. These included improved productivity and corporate

[14] On 27 July 1977.
[15] *Hansard* 3 November 1977.

performance, the macro-economic benefit that would flow from shift away from fixed wages,[16] and a social benefit arising from employees feeling more a part of the company in which they worked.

The new clause contained two sets of proposals. The first would allow payments by a company to an employee trust to be deductible where the amounts were used by the trustees for the payment of interest and principal on loans for the purchase of the company's shares. This provision would, it was suggested, allow companies to bypass the restrictive limits on the issue of shares set by the investor protection committees, so facilitating employee, rather than management, buy-outs. The second set of proposals were focussed on the succession problems in family companies and encouraged transfer of businesses to employee-controlled companies. The specific provisions were capital gains tax relief on the disposal of shares to a co-operative or a company controlled by employees and the treatment of the transfer in as an exempt transfer for inheritance tax.

After indicating the Government's general support for employee share ownership, the then Financial Secretary, Norman Lamont, said that Government would not wish to encourage one form of financial participation over others. But the main concern of Government was the perceived abuse of ESOPs in the US. He suggested that as well as some amendments to the proposed legislation, the Government would wish to see more 'safety devises' introduced. The opposition Labour Party also indicated its general support for ESOPs but, on the basis of the experience in the US, noted that plans tended to be introduced when companies were failing.

Finance Bill 1988

Ian Taylor introduced a new clause to the 1988 Finance Bill to facilitate the use of ESOPs by UK companies. The motivation for the introduction of the new clause can be found in a pamphlet, written in the same year by Taylor and published by the Adam Smith Institute.[17] Taylor identified the benefits of ESOPs, based mainly on his reading of their use in the US, for employees, companies, the economy and society. In respect of the latter, he referred to the importance of personal ownership of property to Conservative philosophy, noting the increase in home ownership between 1951 and 1987 and suggesting that a similar change should be achieved for share ownership. He emphasised that a share owning democracy should be based on individual ownership.

[16] The Government's rationale for introducing legislation to promote profit-related pay was based on the work of Martin Weitzman (1984) *The share economy*, Cambridge Mass.: Harvard University Press. A major strand of the Government's case was that movement away from fixed payment systems would ensure the maintenance of high levels of employment.
[17] Ian Taylor *Fair shares for all the workers*, London: Adam Smith Institute 1988.

A number of changes in taxation were identified by Taylor in *Fair shares for all the workers*.[18] First, there should be removal of uncertainty about the deductibility companies' contributions to ESOPs by giving them statutory recognition and providing clearance procedures. Secondly, owners selling to ESOPs should be allowed to roll-over any gains if they invest the proceeds in the shares of listed companies. Thirdly, the transfer of 25 per cent, rather than the existing 50 per cent. of shares and voting conditions, should be exempt from inheritance tax.[19] Taylor also made suggestions about the length of time the shares could remain in trust, and about the composition of the trust. In order to be consistent with the promotion of individual share ownership it was suggested that any tax reliefs should be withdrawn if shares were not distributed to employees within a maximum period of ten years. On the subject of the trust, Taylor suggested that the trust property be held exclusively for the benefit of employees, their dependents and relatives. The trustees, he proposed, should include those appointed by management, those elected by non-management employees, and independent third parties.

The main proposals were included within the new clause 28 of the 1988 Finance (No 2) Bill, for which Taylor acknowledged the support of the Institute of Directors, Job Ownership Ltd and Field Fisher and Martineau. They included the deductibility of payments to ESOPs and a clearance procedure, roll-over relief if proceeds from the sale of the company to employees were reinvested in listed companies, and a change to the limit on inheritance tax relief on transfer of shares to an ESOP. In speaking to his proposals in the Committee Stage of the Bill, he located employee share ownership in general, and ESOPs in particular, in the context of the Government's programme of widening share ownership through privatisation and other incentives. Taylor also indicated that ESOPs had a role within future privatisation programmes.

Chris Smith (Labour), speaking for the Opposition, indicated that there was little difference between the positions of his Party and that of the Government if the proposals were about real employee ownership and control of the companies for which the employees worked. He contrasted the positions of the two parties by saying that the Conservatives '... are concerned with the individual wealth of the few, whereas the Opposition are concerned with the wealth and control of an enterprise that could be shared by all its employees through employee share ownership schemes'.[20] This was consistent with developing Labour Party policy on social ownership.

[18] Taylor also suggested that there should be amendments to the Companies Act 1985 to allow public companies to give financial assistance to the acquisition of shares by employees.
[19] A transfer of shares to an employee trust is an exempt transfer if the trustees hold more than half the company's ordinary shares and the majority of its voting rights (IHTA 1984, s. 28).
[20] *Hansard*: Standing Committee A, 30 June 1988, col. 825.

He expressed concern on two main aspects of the new clause. First, the proposals did not contain provisions about the control of the fund, and in particular, the appointment of trustees. His preference would have been for trustees appointed by a representative structure of employees. Second he expressed concern that the provisions for roll-over relief would provide opportunities for tax avoidance.

Norman Lamont, then Financial Secretary, also expressed general support for the proposals, but like the Opposition, was concerned about the detail. In particular, he was concerned that the proposed legislation did not contain provisions requiring the shares to be passed to the beneficial ownership of individual employees, nor did it identify to which employees the shares should be distributed. Like the Opposition, the Government were concerned about the possible abuse of the legislation. Possibly with information on the abuse of ESOPs in the US in mind, Lamont suggested the provisions would allow:

> .... the owner of a company to sell a shareholding to an employee trust possibly at a much higher price than he could get elsewhere, and, provided he invested the proceeds in listed securities within six months, he would defer capital gains tax on the sale until such time as he sold those securities. Meanwhile, the company could qualify for tax relief on funds provided to the trustees to finance the purchase. For their part, the trustees could then, as and when they wished, pay all the income arising on the shareholding to just one employee and they could also appropriate to the same person up to 5 per cent of the shares in the company.[21]

The possible abuse of ESOP rules, a concern shared with the Opposition, was to shape the legislation proposed by the Government the following year.

Finance Bill 1989

In late 1988, the accountants Peat Marwick McLintock (now KPMG), who had been commissioned by the Department of Employment to advise on ESOPs, reported that the Government should give consideration to changes in taxation sought by those supporting the schemes. And in November 1988, Industrial Relations Services (IRS), an independent research group, published the results of the first detailed survey of ESOPs in the UK. IRS stated that companies with ESOPs reported improvements in industrial relations and financial performance, and that the only disadvantage suggested by companies related to tax and legal uncertainties.[22] Earlier it had been reported that the ESOP Centre had estimated that at least 2 million

[21] *Hansard*: Standing Committee A, 30 June 1988, col. 824.
[22] *Financial Times* 9 November 1988.

employees could benefit if ESOPs were made easier to introduce, and that New Bridge Street Consultants, one of its sponsors, had drawn up a package of legislation for consideration by the Treasury.[23]

Despite intense lobbying, early in March 1989 there was still doubt about whether the Government would introduce legislation on ESOPs. This was partly because of the poor take-up of profit-related pay schemes for which the Government had introduced favourable tax reliefs. It was also because, although the Government was committed to individualised forms of share ownership, many Conservatives were opposed to collective ownership. Nevertheless, in his 1989 Budget Statement the then Chancellor, Nigel Lawson, announced that he proposed to introduce legislation on ESOPs as part of a package of measures intended to encourage employee share ownership.[24] He expressed the view that '… (T)hose firms with employee share ownership have no doubt that giving the work force a direct personal interest in their profitability and success improves the company's performance'.[25] The legislation on ESOPs would give companies tax relief on contributions they made to ESOPs. Consistent with employee share ownership being an individualistic, as opposed to a collective, interest in the company, a condition of the relief announced in the Budget was that employees should acquire direct ownership of the shares within a reasonable period of time (seven years).

The proposed legislation, contained within clauses 64 to 70 and Schedule 5 of the 1989 Finance Bill, provided for tax relief on companies' contributions to ESOPs,[26] and the withdrawal of such relief under in certain circumstances. More specifically, the Bill provided that payments made by companies to ESOPs would be tax deductible provided that the ESOPs were qualifying trusts and that the funds were used for qualifying purposes. The qualifying conditions cover the trustees, the beneficiaries and the shares which can be purchased by the ESOP. The proposed legislation would require that there were at least three trustees, all resident in the UK, one of whom was a trust corporation, a solicitor or a member of a professional body approved by the Revenue. The majority of trustees must be employees, other than directors, selected by the majority of employees or by persons elected to represent those employees. The functions of the trustees were set out in the legislation. All employees, other than part-time employees and those with less than five years service, must have been offered shares on equal shares. This may have been linked to salary and/or length of service.

[23] *Financial Times* 28 September 1988.
[24] He increased the annual limit on the value of shares that could be given under the all-employee profit-sharing scheme, the monthly limit on contributions under SAYE schemes, and the size of the maximum discount from market value on options granted under SAYE schemes.
[25] *Hansard*, 14 March 1989 col. 301.
[26] Although the Bill and subsequent legislation refers to employee ownership trusts (ESOTs), the acronym ESOP will be continue to be used throughout the paper.

The trust must have acquired shares at a fair value, and the shares must have been passed to employees within seven years of acquisition. Finally, a charge to tax would have arisen on the occurrence of a qualifying event, which would have included a transfer other than a qualifying transfer, retention of shares beyond the seven years, and the use of funds for other than a qualifying purpose.

The debate on the proposed legislation was mainly confined to the Committee stage of the Bill. Here, as well as considering the details of the proposed legislation, the Chairman provided time for a general discussion on the proposed provisions as a whole. This debate revealed both the similarities and differences in views of the main political parties about ESOPs. Although the three main parties expressed general support for the proposed legislation, members of the Committee expressed different views about the role of ESOPs and the type of legislation being proposed. In some cases, opinions were divided along Party lines. The arguments presented in the debate may be grouped under three main headings: (1) reasons for supporting legislation to promote ESOPs; (2) arguments about the details of the proposed legislation; and (3) general arguments about the type of legislation that was being proposed.

Reasons for Supporting Legislation to Promote ESOPs

The fundamental difference between Labour and Conservative MPs was identified by Alan Beith (SLD) who suggested that Labour Members saw participation in ESOPs as giving employees a stake in control of the company, whereas Conservative Members argued that employees should not be looking for control but for the ability to participate in profits and capital of the business.

Conservative Members saw ESOPs as providing a way of extending the property-owning democracy. For example, Tim Boswell stated that '.... we want people to have more influence on their lives, more say about what they can do, and a greater participation in the control of their affairs. To achieve that is an imperfect and difficult task, but a task made much easier by a wide dissemination of property and interests, at all levels and in many different ways'.[27] He went on to suggest that ESOPs were another mechanism for allowing individuals to participate in a capitalist economy. The basic claim that there had been a spread of capital ownership under Conservative Government was challenged by the Opposition. Calum Macdonald (Labour), for example, noted that there had been a decline in an 'individual shareholding democracy' under the Conservative Government with a reduction in individual share ownership as a consequence of the growth in ownership by

[27] *Hansard*, Standing Committee G, 6 June 1989 col. 299.

institutional investors. It was noted that 35 per cent. of shares were held by individual shareholders in 1979, compared with only 25 per cent. a decade later.

The spread of a property, or capital, owning democracy meant for Conservatives an extension of ownership by individuals. It is therefore essential that the ESOP structure provided a mechanism by which employees, as individuals, could acquire shares. As individuals, employees were acquiring the right to participate in a company's profits and capital growth. They were not, as individuals, acquiring the opportunity to participate in decision making, or at the extreme, to control the company. This contrasts with the position of Labour Members who considered collective ownership to be important. For example, Nicholas Brown (Labour) indicated that the structure of ESOPs '... could lead to genuine worker control and positive and constructive participation in management decision making',[28] rather than turning workers into 'mini-capitalists'. This was consistent with the adoption of social ownership by the Labour Party. As noted by Win Griffiths (Labour), the proposed legislation did not allow for collective ownership under the ESOP scheme.

The problems of collective ownership were noted during the debate. In particular, attention was drawn to the potential problem that trade unions might have in dealing with companies that had ESOPs. Lewis Moonie (Labour) referred to the situation where employees control the majority of shares in a company '... will lead to conflicts in the traditional roles of labour and capital and will blur the present, clear distinctions and interests of the two groups'.[29] The dilemma of trade unions in representing the interests of employees and protecting their investments was identified by Nicholas Brown (Labour), although he suggested that in practice trade unions were able to deal with this tension.

Comments from both Conservative and Labour Members indicate agreement on an economy in which there are many types of business enterprise, and ESOPs fit into this overall form. Norman Lamont (Conservative) stated that:

> In a free enterprise economy, there is room for many different forms of ownership, which can include a number of companies where a majority of shares are owned by the labour force. If the increasing awareness of and interest in ESOPs results in more worker-owned companies, I should not regret that.[30]

For Labour, Nicholas Brown referred to the Party's policy review document 'Productive and Competitive Economy' which includes ESOPs alongside other forms of public ownership.

[28] *Hansard*, Standing Committee G, 6 June 1989 col. 286.
[29] *Hansard*, Standing Committee G, 6 June 1989 col. 302.
[30] *Hansard*, Standing Committee G, 6 June 1989 col. 304.

Details of the Proposed Legislation

The remarks of the Financial Secretary, Norman Lamont, provide clues to the nature of the proposed legislation. In particular, they indicate the concern that the legislation may be abused. He noted that in the US, the tax reliefs available for ESOPs were used as a financing benefit for companies. Lamont also remarked that ESOPs were used in the US in lieu of pensions and benefits funds, and as anti-takeover, or 'poison pill', devices. As well as wishing to prevent abuse, he wanted ESOPs to be used for the benefit of all employees on equal terms rather than, as was the case in some US ESOPs, for the benefit of managers. Finally, he stated that ESOPs '... should certainly not be vehicles by which former rich proprietors purport to give control of their companies away to the labour force, while retaining control'.[31] The proposed rules contained within Schedule 5 on the composition of trustees were intended to ensure that the trustees were independent of former owners, and of current owners other than employees.

Ian Taylor argued that there should be greater flexibility about the composition of trustees. In particular he suggested that banks, including Unity Trust, may have had strong views about the composition of trustees which may affect their lending decisions. Norman Lamont argued strongly for the structure contained within the proposed legislation. In response to the view expressed by Ian Taylor, he suggested that as companies could guarantee loans, there was no reason to suspect that banks would not lend because the majority of trustees were from the work force. He reminded the committee that the trustees would exercise discretion over a large number of shares, and would be able to exercise the voting rights over a period of up to seven years. There may be differences between the interests of companies' owners and management on the one hand, and the best interests of their employees on the other, for example, in a takeover. In particular, the Government did not wish ESOPs to be used as poison pill device to entrench existing management. He then stated that as ' ... the sole purpose of the trust is to benefit employees, we should ensure that at all times employees' interests take precedence'. For this reason, the proposed provisions stipulated that there should always be a majority of employee trustees, with an independent professional trustee to supply expert guidance. In response to the point made by Nick Brown that individuals would be unwilling to serve as trustees because of onerous responsibilities, Lamont stated that the obligations placed on trustees are no different from those placed on trustees generally.

Two other specific issues were raised during the debate: capital gains tax relief on the sale of shares by owners to ESOPs and the use of share option schemes within the overall ESOP structure. Earlier proposals for legislation on ESOPs had included provisions for capital gains tax relief. On this subject,

[31] *Hansard*, Standing Committee G, 6 June 1989 col. 305.

Lamont suggested that it would be difficult to devise a relief that was properly targeted and that any legislation would have had to be complex in order to ensure that it was not open to abuse. In response to an amendment proposed by Ian Taylor on the use of share option schemes to distribute shares to beneficiaries, the Financial Secretary commented that the legislation would be complicated. Further, Lamont indicated that as there were no representations during the Government's consultation, he was not convinced that there was a demand for legislation that would allow the use of option schemes to distribute shares.

General Arguments about the Type of Legislation being Proposed.

As well as debating the general principles of ESOPs and some detailed parts of the proposed legislation, general arguments were put forward about the overall character of the legislation. First, the legislation was introduced to remove uncertainty about corporation tax relief on payments to ESOPs. As indicated above, this uncertainty was seen as the main factor inhibiting the establishment of ESOPs by UK companies. A question was raised as to whether corporation tax relief would still be available to case law ESOPs. Lamont confirmed that the relief would still be available for case law ESOPs, but noted that '... the lengths and devices necessary to obtain the certainty of corporation tax relief involved much work and expense for employers'.[32] The proposed legislation would make it easier to obtain corporation tax relief, and by implication, it was expected that companies would follow this route.

Second, although the main purpose of the legislation was to remove uncertainty about the available, there was an element of social engineering in the proposals. Tax preference, mainly in the form of certainty of tax deductibility, was being offered to a particular type of business medium with some loss of tax revenue.[33] The proposed legislation, which offered preferential treatment to ESOPs with certain characteristics, was seen by Calum Macdonald (Labour) as containing a contradiction between proposed legislation and Government policy which favoured tax neutrality. While offering general support to ESOPs, he stated that the Government '... are instituting what on other occasions they would call tax distortions not for economic reasons, but simply as a means of social engineering'.

Finally, the proposed legislation was seen as complex and lacking elements that would make it attractive enough to companies so as to increase the use of ESOPs. Ian Taylor commented that: (1) the proposed rules on

[32] *Hansard*, Standing Committee G, 6 June 1989 col. 304.
[33] The Financial Secretary indicated that the cost of the provision would be £20m per annum depending on take-up.

employee representatives on trust were complex, (2) unapproved or approved share option schemes could not be used within the overall structure; (3) burdens were placed upon trustees; and (4) there were penal clawbacks and penalties if qualifying conditions were not met. In addition, the proposed legislation did not offer capital gains tax relief for vendors of shares to ESOPs. He noted that: 'We introduce a marvellous new concept but then find so many conditions among the qualifying terms that if we are not careful we return to the Committee 12 months later and find that the rate of take-up by the commercial sector of a piece of legislation has not been so enthusiastic as we might have wished'.[34]

Subsequent Events

As Ian Taylor predicted, the legislation contained in the Finance Act 1989 did not succeed in encouraging companies to use the qualifying ESOP structure.[35] This may have been, in at least part, because companies could still use the case-law structure. Williams[36] suggested that the choice between statutory and case-law ESOPs depended on the circumstances of the company. Statutory ESOPs provided the certainty of corporation tax relief, subject to meeting the qualifying conditions, but the relief was clawed back if there was a chargeable event. On the other hand, although there was some uncertainty about the relief with case-law ESOPs, there was no clawback once the relief has been given, and there was greater flexibility.[37] The next decade saw the introduction of new legislation to make the use of statutory ESOPs attractive. In particular: (1) provisions for roll-over relief on certain transfers to ESOPs were included in the Finance Act 1990; (2) relief for the costs in setting up ESOPs was provided in the Finance Act 1991; (3) amendments to the rules on trustees so as to allow a 'paritarian' structure[38] were contained within the Finance Act 1994, as was an extension to twenty years of the period within which shares must be distributed

[34] *Hansard*, Standing Committee G, 6 June 1989 col. 291.

[35] In a letter to the *Financial Times*, 10 May 1989, Ian Brennan of New Bridge Street Consultants commented that the provisions for a 'severely limited type of ESOP trust' could be seen as a step backwards. He expressed the view that the legislation would subsequently be improved.

[36] David F. Williams (1991) *Taxation of employee share schemes. Third Edition*. London: Butterworths.

[37] Speaking in the debate at the Committee stage of the 1990 Finance Bill, Alan Beith (Liberal Democrat) noted that companies preferred the relative uncertainty of the case law provisions to the restrictive statutory rules, and as a result statutory ESOPs had not been created. (Hansard, 16 May 1990 col. 959).

[38] The new provision meant that, instead of there having to be a majority of trustees who are employees, there can be a 50/50 split between employees and others, with a casting vote held by a professional trustee. David Cohen (*Financial Times* 16 April 1994) notes that 'paritian' trust is a term used by the Inland Revenue that '... appears until now to have escaped the notice of dictionary writers and trust lawyers alike').

to employees; and (4) provisions to enable savings-related share option schemes to be used within a qualifying ESOP were included in the Finance Act 1996. There were also administrative changes to facilitate the use of statutory ESOPs. For example, in May 1990 the Inland Revenue announced a formal clearance procedure to enable trustees to obtain confirmation that a particular trust would be accepted as a qualifying employee share ownership trust,[39] and later in that year the Inland Revenue indicated that it would examine and comment upon draft trust deeds. Not all the problems with the use of statutory ESOPs had to do with taxation. In particular, there was concern that directors or employees acting as trustees might be committing a criminal offence under the Financial Services Act 1986. An exemption from the 'collective investment scheme' provisions of the Act was given in 1995.

The legislative effort put into ESOPs was considerable. Despite this effort, there were some indications that there had been little use of statutory ESOPs. At the Committee Stage of the 1999 Finance Bill, the Financial Secretary, Stephen Timms, stated that there '... had been fewer than a dozen in the past 10 years'.[40] However, Pendleton reports that approximately 30 statutory ESOPs had been created up until the middle of 1996, mainly by private companies.[41] The change in the Finance Act 1996 which allowed the use of SAYE share option schemes within the ESOP structure made ESOPs attractive to companies operating SAYE share option schemes.[42] There were reports in 1997 that a number of listed companies were using ESOPs in their share option schemes in order to gain preferential tax and accounting treatments.[43] Pendleton reported that by March 2000 there were 399 statutory ESOPs, mainly within listed companies. The attraction to companies was that by using the ESOP structure within their SAYE share option schemes they could obtain corporation tax relief for the difference between the exercise price and the fair value of the shares. There was concern that the Government would come under pressure to close what was seen to be a £500 million 'tax loophole'. Malcomn Hurlston, Chairman of the Employee Share Ownership Centre is quoted as saying 'In the past year we have noticed a dramatic increase in the number of statutory ESOPs linked to SAYE schemes. It is possible that the Treasury has not budgeted the cost to the Exchequer of what is happening. We are concerned that this use of the system could lead to changes which would have detrimental

[39] Inland Revenue Press Release 9 May 1990.
[40] House of Commons Standing Committee H (pt 7).
[41] Pendleton, A (2002) *Employee ownership, participation and governance: A study of ESOPs in the UK*. London: Routledge.
[42] The interaction between tax provisions which potentially gives companies relief for the discount and growth in the value of shares within the trust, together with favourable accounting treatment under UITF *Abstract 17 Employee share schemes* made ESOPs attractive to companies using SAYE share option schemes. Most of these schemes are within listed companies.
[43] *Guardian* 5 May 1997 'Share scheme hijacked' by Lisa Buckingham and Roger Cowe.

effects on the potential benefits to be accrued by the many'.[44] These fears may not have been unfounded as Barbara Roche, then Financial Secretary, told the Commons in July 1999 that there was concern that statutory ESOPs were being used for purposes other than those for which they were originally intended.[45]

Legislation on approved employee share ownership plans (AESOPs) in the Finance Act 2000 has now largely replaced the need for that on ESOPs, although the Government has indicated that it does not propose to withdraw the tax reliefs for such trusts. To facilitate the movement to AESOPs, the Finance Act 2000 contains provisions to allow companies to transfer shares from statutory ESOPs into AESOPs without any clawback of any previous corporation tax relief.

5. DISCUSSION

The debate on the introduction of legislation that would provide companies, subject to meeting several qualifying conditions, with relief on their contributions to ESOPs can be understood against the background of the evolution of ESOPs in the US, and against the political climate in the UK during the late 1980s. Not only was the ESOP structure transferred from the US, its uses and abuses were to influence the legislation proposed by the UK Government in 1989. Subsequent revisions to the rules on statutory ESOPs allowed the legislation to be used mainly in ways not foreseen by the legislators.

Louis Kelso was said to have conceived the ESOP structure as a method of allowing employees to acquire shares that would be paid for out of the pre-tax profits of the companies for whom they worked. The concept was viewed by Kelso as a solution to the problems he identified in his 'binary' economics, that is, of providing employees with a source of capital income to compensate for the declining value of their labour with advances in technology. As such, the overall political philosophy underlying Kelso's work on ESOPs has been seen as providing a third way between the principles of socialism and capitalism. It might have been the attractiveness of such principles that formed the basis of Russell Long's sponsorship of legislation that provided tax benefits to companies, their owners and providers of debt finance to ESOPs. At the centre of the legislative provisions supporting ESOPs was the Employee Retirement Income Security Act of 1974 (ERISA), a piece of legislation intended to encourage the establishment of company pension schemes.

[44] *Guardian* 12 May 1997 'Lobby anger on tax' by Roger Cowe.
[45] This, she said, was to help family-owned firms to transfer ownership to employees. (House of Commons Hansard Debates for 14 July 1999 (pt. 14).

Although the ESOP concept had been sold on the principle of enabling employees to acquire capital, the ESOP structure was used and abused in ways not entirely consistent with the intentions of the legislators. Kelso himself, as an investment banker, was associated with some of these abuses. In particular, the ESOP concept became associated with the transfer of 'troubled' companies to their employees, with employees sometimes acquiring shares for more than their fair value. ESOPs were used by companies as a tax efficient method of acquiring loan finance. Companies under threat of being taken over also used ESOPs as a poison pill device. Although it was argued that such a use of ESOPs was to the benefit of employees, it was also seen as a method by which under-performing management could become entrenched. ESOPs were also used to transfer ownership to employees with the original owners retaining control.

The transfer of the ESOP concept to the UK required the presence of banks willing to fund ESOPs, companies that could use them, and a regulatory framework that would make their use possible. By the late 1980s there were a number of banks, including the Unity Trust Bank, that were willing to provide finance for ESOPs, and the Government's privatisation programme in particular provided situations in which ESOPs could be used. Finally, the case-law ESOP structure was devised in order to provide companies with tax relief on payments to ESOPs. Although there was some uncertainty about whether relief would in fact be available, the creation of the case-law ESOP structure demonstrates the effectiveness of financial engineering to make possible the transfer of a structure from one regulatory system to another.

Uncertainty about the availability of tax relief on payments by companies to ESOPs was seen as preventing the widespread use of ESOPs in the UK. As in the US, ESOP supporters lobbied for legislation that would make the use of the structure more attractive. In the UK this would be by introducing legislation that would eliminate uncertainty about the availability of relief on payments by companies to ESOPs, and provide reliefs to shareholders on the transfer of shares to ESOPs. Although the Conservative Government was initially reluctant to introduce such legislation, principally on the grounds of its potential abuse, it eventually did introduce legislation in 1989. At that time the legislation received support from the three main political parties.

The rhetoric of the debate would suggest that Conservative Party support was associated with principles of a property, or capital, owning democracy. Although such principles were long held within the Party, they had greater prominence during the 1980s. Employee share ownership was seen as one of several methods of extending a property-owning democracy. For the Conservatives, as well as for the Social and Liberal Democrats, however, this meant the ownership of shares by individual employees. The legislation therefore provided for the transfer of shares to individual employees within

a limited amount of time. This contrasts with Labour Party support for ESOPs being linked to collective ownership by employees. The Labour Party also emphasised that it was important that employees had control, or at least influence, over the companies in which they held shares.

The 1980s saw a change in the ownership of industry as a result of the Conservative Government's privatisation programme. This influenced policy on ESOPs in the Conservative and Labour Parties. Management and management/employee buy-outs of previously publically owned entities were one way of transferring the entities to private ownership. Support for ESOPs can be seen as facilitating buy-outs involving employees. The Labour Party was also changing its views on the ownership of industry in the 1980s, and at least a part of the Party was moving away from a commitment to Clause IV and towards a concept of 'social ownership'. ESOPs had a place within the overall concept of social ownership. In this context there was support for the use of ESOPs from both the Trade Unions and the Labour Party. This was particularly seen in the privatisation of bus companies.

The legislation introduced by the Conservative Government provided relief for companies' payments to ESOPs only when several qualifying conditions were met. One set of conditions ensured that shares were transferred to employees within a period of seven years. This was consistent with the Conservative Party's concept of a property-owning democracy, and contrary to the Labour Party's views about collective ownership. The other conditions would appear to have been intended to prevent the abuse of ESOPs. The legislation therefore included provisions to prevent the beneficiaries of ESOPs being a restricted group of employees, such as senior management, and to ensure that employees, or their representatives, had control over the shares held in trust. The legislation further provided that any relief would be clawed back in the event of a breach of any of the qualifying conditions. Not only was the legislation restrictive, it failed to meet some of the demands of ESOP supporters including their demands for capital gains tax rollover relief on the sale of shares to ESOPs and the ability to use share option schemes within the structure of statutory ESOPs.

In drawing up the legislation the Government had to achieve a balance between wishing to provide reliefs to facilitate, or promote, the use of a particular structure and the desire to prevent abuse. The low initial use of the legislation would suggest that the Government weighed too heavily on the side of caution in order to prevent abuse. As predicted during the Committee stage debate, however, the Government subsequently had to introduce legislation to make the use of statutory ESOPs more attractive. Among the changes introduced was a provision to allow SAYE share option schemes to be used as a method for distributing shares to employees. Many listed companies took advantage of this in order to obtain tax relief on the difference between the fair value and the exercise price of options. It would

seem that the provisions for statutory ESOPs were used mainly for such arrangements, something that was regarded as an abuse of the legislation. Therefore, as with some previous tax provisions, such as those for the business expansion scheme and for profit-related pay, the relevant provisions were mainly used for purposes other than those that the legislators had in mind when introducing the legislation.

8

What's in a Name?

JDB OLIVER*

THIS STORY CONCERNS the arrangements with the Republic of Ireland for relief from double taxation. Three or four years ago the writer was discussing a cross-border issue with an Irish professional colleague (Mary Walsh) and was looking at the 1998 Protocol[1] to the 1976 UK/Ireland[2] double taxation convention. In doing so we referred back to our respective countries' texts of the 1976 Convention[3] itself.

We found ourselves in disagreement on the description given to our two states in the 1976 Convention. As you will see in the appendix the United Kingdom version of the treaty (and of the 1976 and 1994 amending Protocols[4]) refers to the 'Republic of Ireland' and furthermore describes the treaty (or those amending Protocols) as being between 'the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Republic of Ireland.' The Irish version, on the other hand, refers to 'Ireland' and to the treaty as being between 'the Government of the United Kingdom and the Government of Ireland.'

Was this difference in terminology intended, how did it come about, how long has it been going on and does it have any significant impact on the operation of the treaty? The different descriptions seem to have been deliberate, and did not arise because of any discrepancy between the United Kingdom text of the treaty itself and the text as scheduled to the Order in Council.[5]

* This presentation is extracted from a more detailed paper written jointly by the speaker and Mary Walsh of the Dublin Office of PricewaterhouseCoopers. The authors of that paper are grateful to Colm Gleeson, M.A., for his review of the historical aspects.

[1] In the U.K. see S.I. 1998 No. 3151. In Ireland see S.I. 1998 No. 494.

[2] For ease of reading, the authors have, except where the context otherwise requires, used the term UK or United Kingdom to refer to the United Kingdom of Great Britain and Northern Ireland. They have likewise used the term Ireland to refer to the Republic of Ireland, as the context requires.

[3] In the UK see S.I. 1976 No. 2151. In Ireland see S.I. 1976 No. 319.

[4] In the UK see S.I. 1976 No.2152 and S.I. No. 1995 No.764. In Ireland see S.I. 1995 No.209.

[5] See Treaty Series: Cmnd. 6591 and S.I.1976 No.2151. The 1976 and 1994 Protocols were not laid before Parliament as Protocols but only as Schedules to draft Orders in Council.

HOW DID IT COME ABOUT?

How did the situation arise where, with a common language, there were divergent texts?[6] One explanation may be that the 1976 Convention and the subsequent 1976 and 1994 Protocols were each 'Done in two originals'. Normal United Kingdom treaty practice is for the agreement to be 'Done in duplicate,' which would signify identical texts. Normal Irish treaty practice is likewise for the agreement to be 'Done in duplicate.'[7] It seems therefore that one original text (the Irish version) described Ireland as 'Ireland' and the other original text (the United Kingdom version) as 'the Republic of Ireland'.[8]

The 1998 Protocol on the other hand presents no such problem. This Protocol is also described as 'Done in two originals' but in this case the two versions are the same. *Both* texts describe the Protocol as being between 'the government of Ireland' and 'the government of the United Kingdom of Great Britain and Northern Ireland.' From a UK perspective, it thus uses the term 'Ireland' rather than 'the Republic of Ireland' and, from an Irish perspective, it now includes a specific reference to Northern Ireland.

In three places the text of the 1998 Protocol makes specific reference by name to one country or the other, as opposed to a reference to a contracting state. One occasion is in the provision for entry into force[9] where the respective references are to 'the United Kingdom' and to 'Ireland'. The other two occasions are both in the new dividend article[10] where there was a need to refer specifically to the respective domestic legislative provisions in defining the term 'superannuation scheme' ('in the case of Ireland' or 'in

[6] All the agreements described in this article (the 1926 Agreement, the 1976 Convention and all the amending agreements and protocols) were done in English. The 1926 Agreement was concluded before the revival of the Irish language was adopted as an objective by Ireland and by the time of the 1976 Convention this objective had been abandoned. Only four Irish language versions of treaties survive.

[7] When *two* languages are used then the practice seems to be for the treaty to be 'Done in duplicate in the English and [Arabic] languages, both texts being equally authoritative.' Multiple language versions are also possible, and the text of the Ireland/Belgium treaty is typical: 'Done in duplicate at Brussels, this 24th June 1970, in the Irish, English, French and Netherlands languages, the four texts being equally authoritative.'

[8] On the other hand the 1998 Protocol is also described as 'Done in two originals' but in this case the two texts are the same.

[9] Article VII.

[10] Article II of the Protocol deleting article 11 of the Convention and replacing it by a new Article 11.

New Art.11(2)(b)(i) reads: '.....the term "superannuation scheme" means..... in the case of *Ireland*, a sponsored superannuation scheme within the meaning of.....' (Emphasis added).

New Article 11(3) reads: 'The term "dividends" for United Kingdom tax purposes includes any item which under the law of the United Kingdom is treated as a distribution and for *Irish* tax purposes includes any item which under the law of *Ireland* is treated as a distribution.' (Emphasis added). In the United Kingdom version of the text of the 1976 Convention the equivalent reference, in Old Article 11(4), is to 'Republic of Ireland tax purposes' and to 'the law of the Republic of Ireland.'

the case of the United Kingdom' as the case might be) and in defining dividends (as a distribution 'under the laws of Ireland' or 'under the laws of the United Kingdom' as the case might be).

The Inland Revenue Press Release[11] on the 1998 Protocol throws some light on the point, stating that:

> In line with practice following the Belfast Agreement the term 'Ireland' is used in the Protocol whereas the term 'Republic of Ireland' was used in the 1976 Convention and previous Protocols.[12] The term 'Ireland' as used in the Protocol has the same meaning as 'Republic of Ireland' in the Convention and previous Protocols.

The subsequent debate on the draft Order in the United Kingdom House of Commons' Third Standing Committee on Delegated Legislation adds little however. The difference in the wording in the Order compared with the original treaty was raised in the debate by the Opposition spokesman but the Financial Secretary simply referred him to the Inland Revenue press release and added: 'The treaty thus reflects changing circumstances.'[13]

The Revenue Commissioners' Press Release[14] makes no reference to the point since in the Irish texts there was no change. The Irish statutory instrument giving effect to the 1976 convention,[15] as also the instruments giving effect to the subsequent protocols,[16] already used the same language as the 1998 Protocol and referred to 'Ireland' and *not* to the 'Republic of Ireland'.

HOW LONG HAD THIS BEEN GOING ON?

How long had this been going on? What was the position under the arrangements which preceded the 1976 Convention? Did similar differences arise there?

Let us at this point go back to 1926. What arrangements if any were to be made to avoid double taxation following the creation of the Irish Free State in cases where a resident of one country derived income from sources

[11] Inland Revenue Press Release – Double Taxation Agreements: Hong Kong, Ireland and Malaysia. 9 November 1998.
[12] See S.I. 1976 No.2151, S.I. 1976 No. 2152 and S.I. 1995 No. 764.
[13] Third Standing Committee on Delegated Legislation: H.C. Deb. 2 December 1998, Cols. 6 and 10.
[14] Revenue Commissioners Press Release – Signature of Protocol between Ireland and the United Kingdom of Great Britain and Northern Ireland amending the existing Tax Convention (4 November, 1998).
[15] S.I. No. 319 of 1976.
[16] S.I. No. 319 of 1976 (which gave effect both to the Convention and to the first protocol) and S.I. No.209 of 1995.

in the other? (Of course if Gladstone had not extended income tax to Ireland in 1853 the issue might not have arisen but there we are). At that time (1926) the UK did not have any model treaty of its own to follow, although it was already involved in the League of Nations discussions on the issue and on the allocation of taxing rights between states according to the nature of the income – a schedular approach.

The solution adopted was to allocate taxing rights to the country of residence. The agreement provided that (i) 'any person who proves to the satisfaction of the Commissioners of Inland Revenue that for any year he is resident in the Irish Free State and is not resident in Great Britain or Northern Ireland' was to be exempt from 'British income tax for that year in respect of all properties situate and all profits or gains arising in Great Britain or Northern Ireland' and (ii) 'any person who proves to the satisfaction of the Revenue Commissioners that for any year he is resident in Great Britain or Northern Ireland and is not resident in the Irish Free State' was to be exempt from 'Irish Free State income tax in respect of all properties situate and all profits or gains arising in the Irish Free State.'[17] There was a separate provision dealing with the position of dual residents.

The original (1926) agreement was between 'the British Government' and 'the government of the Irish Free State' in both versions so there was common ground at this time. This common ground extended to the first amending agreement, made in 1928, which extended the 1926 agreement to cover super-tax and sur-tax, respectively. In the subsequent amending agreements differences arose in the descriptions given to the respective governments in the respective texts of the amending agreements and these are set out in the appendix and are considered further below.

[17] The territorial extent of the Irish Free State had been determined originally by the Government of Ireland Act, 1920, which provided for Northern Ireland to comprise 'the parliamentary counties of Antrim, Armagh, Down, Fermanagh, Londonderry and Tyrone', and for 'Southern Ireland' to comprise the rest of Ireland. Southern Ireland never functioned as such and the position was overtaken by the 1921 Treaty which gave jurisdiction to the Irish Free State equivalent to that originally envisaged for Southern Ireland – i.e. the entire island minus Northern Ireland.

The description 'Irish Free State', as used in the 1926 agreement, was derived from the treaty signed in 1921 between 'Great Britain and Ireland' which provided effectively for the partition of Ireland. This treaty was given effect by the United Kingdom in the Irish Free State (Agreement) Act 1922. Under Article 1 of the treaty as scheduled to that Act 'Ireland shall have the same constitutional status ... as the Dominion of Canada ... and shall be styled and known as the Irish Free State.' The Irish Free State Constitution Act 1922 made provision for the constitution of the Irish Free State and the Irish Free State (Consequential Provisions) Act 1922 provided that, subject to certain provisions, the Government of Ireland Act 1920 was to cease to apply 'to any part of Ireland other than Northern Ireland'. The treaty was given effect to by Ireland in the Constitution of the Irish Free State (Saorstát Éireann) Act 1922, the first enactment of 'Dail Éireann, sitting as a Constituent Assembly in this Provisional Parliament' and the treaty (in the same version) is scheduled to that Act.

POLITICAL DEVELOPMENTS IN IRELAND

The differences reflected political developments in Ireland. The first was in 1937 when the Irish Free State drafted itself a new constitution. Article 4 of the new constitution provided that 'The name of the state is Éire, or, in the English language, Ireland.' Article 2 set out a territorial claim to Northern Ireland, stating that: 'The national territory consists of the whole island of Ireland, its islands and territorial seas.' Article 3 adapted this claim to the *de facto* position of Northern Ireland as part of the United Kingdom by stating that: 'Pending the re-integration of the national territory, and without prejudice to the right of the Parliament and Government established by this Constitution to exercise jurisdiction over the whole of that territory, the laws enacted by that Parliament shall have the like area and extent of application as the laws of Saorstát Éireann [the Irish Free State] and the like extra-territorial effect.' Therefore tax jurisdiction continued to be limited to the area of the Irish Free State and was not extended to Northern Ireland.

The change of name effected by the 1937 Constitution, but not the other constitutional changes, was given effect by the United Kingdom in the Éire (Confirmation of Agreements) Act 1938 under which the territory 'which … was required to be styled and known as Irish Free State shall be styled and known as Éire.'[18]

The next development in Ireland on 'styling' was in 1948, when Ireland declared itself a republic and on 21 December 1948 The Republic of Ireland Act, 1948 was signed by the President. This repealed the Executive Authority (External Relations) Act 1936. Although the 1948 Act did not change the name of the country (which remained Éire in the Irish language and Ireland in the English language), it provided that 'the description of the State shall be the Republic of Ireland'. In the debate on the Bill, the taoiseach, John A. Costello introduced the provisions of section 2 in the following terms:

> The Bill is a simple Bill but it has tremendous and, I believe and hope, very beneficial results. The first section repeals the External Relations Act. I have dealt fully with that. Section Two provides: 'It is hereby declared that the description of the State shall be the Republic of Ireland'. That section is so obviously necessary that it requires no advocacy on my part to commend it to the Dáil. Deputies will recall that under the Constitution the name of the State is Éire or, according to Article Four, the name of the State is Éire or, in the English language, Ireland. Now, this section does not purport, as it could not, to repeal the Constitution. There is the name of the State and there is the

[18] Éire (Confirmation of Agreements) Act 1938 s.1. The Act confirmed certain trade and financial agreements but made no reference to the new constitution, or to the territorial claim, which the UK did not accept.

> description of the State. The name of the State is Ireland and the description of the State is the Republic of Ireland. That is the description of its constitutional and international status. Deputies are probably aware of the fact that tremendous confusion has been caused by the use of that word 'Éire' in Article 4. By a misuse by malicious people of that word, 'Éire', they have identified it with the Twenty-Six Counties and not with the State that was set up under this Constitution of 1937.
>
> In documents of a legal character, such as, for instance, policies of insurance, there is always difficulty in putting in what word one wants to describe the State referred to. Section 2 provides a solution for these difficulties, and those malicious newspapers who want to refer in derogatory tones to this country as 'Éire' and who have coined these contemptuous adjectives about it, such as 'Éireannish' and 'Éirish', and all the rest of it, will have to conform to the legal direction here in this Bill.
>
> Section 2 does these subsidiary things but it does more than that. It does something fundamental. It declares to the world that when this Bill is passed this State is unequivocally a republic. It states that as something that cannot be controverted or argued about and we can rely, I think and I hope, on international courtesy to prevent in future this contemptuous reference to us and the name of our State being used for contemptuous purposes, as it has been, by some people and by some organs in the last few years.[19]

Although signature by the President would normally bring an act into force in Ireland, in this case enactment was held over until 18 April 1949. The latter date was Easter Monday and was the 33rd anniversary of the Easter Rising of 1916.

The United Kingdom responded to this development with the Ireland Act 1949[20] under which the *de facto* existence of Ireland as a republic was recognised and it was recorded that 'the part of Ireland heretofore known as Éire ceased as from [18 April 1949][21] to be part of His Majesty's Dominions.'[22] The Act declared that that part of Ireland (i.e. Éire) 'may in any Act, enactment or instrument passed or made after the passing of this Act be referred to, by the name attributed thereto by the law thereof, that is

[19] John A Costello on The Republic of Ireland Bill, 1948, Dáil Éireann debates, vol 113, cols 394–398, 24 November 1948.

[20] The preamble to the Ireland Act 1949 reads: 'An Act to recognise and declare the constitutional position as to the part of Ireland heretofore known as Éire, and to make provision as to the name by which it may be known and the manner in which the law is to apply in relation to it; to declare and affirm the constitutional position and the territorial integrity of Northern Ireland and to amend, as respects the Parliament of the United Kingdom, the law relating to the qualifications of electors in constituencies in Northern Ireland; and for purposes connected with the matters aforesaid.'

Some account of this Act, and earlier developments, is to be found in Constitutional Law by Hilaire Barnett (Cavendish Publishing).

[21] The same date that the corresponding Irish act came into force, but with less resonance in a British context.

[22] Ireland Act 1949, s.1.

to say, as the Republic of Ireland.'[23] The Act also declared that 'Northern Ireland remains part of the United Kingdom.'[24] Rather confusingly (in the context of subsequent nomenclature that might otherwise have been identical) in the 1949 Act the United Kingdom adopted as a *name* the term that Ireland enacted in its equivalent 1948 Act as a *description*.[25]

THE CHANGING DESCRIPTIONS

Meanwhile the 1926 double taxation agreement had remained in place in its original form (with the 1928 amendment) in the domestic law of both countries.[26] A further amending agreement appeared in 1947.[27] Here a difference emerged (see appendix) in the way in which the respective governments described themselves as a result of the 1937 changes described above. Ireland had moved on and its version of the agreement described the agreement as being between 'the Government of Ireland' and 'the Government of the United Kingdom' (without specific Northern Ireland references). This formula was repeated (again without specific Northern Ireland references) in the Irish version of the 1959, 1960, 1973 and 1975 amending agreements.

In the United Kingdom version of the 1947 agreement it was described as being with the 'Éire Government', in conformity with the Éire (Confirmation of Agreements) Act 1938, rather than with the 'Irish Government' while the United Kingdom version of the 1959[28] and 1960

[23] *Ibid.* s.1(3).
[24] *Ibid.* s.1(2).
[25] The name of the country had been set as Ireland in Article 4 of the 1937 Constitution. The Constitution prohibits at Article 15 the enactment of any law which is in any respect repugnant to the Constitution. It is thus not possible, from an Irish perspective, to change the name of the country otherwise than by Constitutional referendum.
[26] See n.32 below.
[27] Enacted in the United Kingdom as s.37 F.A.1948. The agreement itself was triggered by the introduction in the United Kingdom, in the Finance (No.2) Act, 1945, of the so-called 'net UK rate' which limited the amount of income tax which could be repaid to the tax exempt shareholder, or shareholder without a tax liability, in relation to dividends paid by UK resident companies.
[28] Enacted in United Kingdom domestic law as F.A.1959 s.29 and Sch.7. The 1959 agreement recites that it had been entered into because doubts had arisen as to the effect of United Kingdom dividend-stripping legislation, contained in s.4 Finance (No.2) Act 1955, on the exemptions provided to Irish residents and, in relation to United Kingdom residents, the effect of the provisions in s.51(2) of the Irish Finance Act 1958 which also enacted dividend-stripping legislation. The Agreement confirmed that the exemptions were restricted by the provisions of s.4 and s.51(2) respectively.

The doubts referred to above were later to be examined by the UK courts in *C.I.R. v Collco Dealings Ltd.*(1961) 39 T.C.509; for a discussion of the treaty over-ride issues in that case see *Treaty Over-ride and the construction of consolidating legislation – Padmore v IRC (No.2)* [2001] B.T.R. 227.

agreements[29] referred to the 'Government of the Republic of Ireland' (in conformity with the Ireland Act 1949) but, like the Irish version, referred to the 'United Kingdom government' and thus omitted specific reference to Northern Ireland. This omission did not however carry through to the 1973 and 1975 amendments[30] where the agreements are described as being between 'The Government of the United Kingdom of Great Britain and Northern Ireland' and 'The Government of the Republic of Ireland'.

There seem to be two principal reasons for the differences in description which emerged in the 1947 and later amendments to the 1926 Agreement, as well as subsequently in the 1976 Convention and the first two protocols thereto. One reason may have been the territorial claim to Northern Ireland set out in the 1937 Irish Constitution. Ireland therefore preferred the agreement to be signed with the government of the United Kingdom and to omit any specific reference to Northern Ireland (as in the 1947, 1959, 1960, 1973 and 1975 amendments). The United Kingdom, by maintaining references to Éire (in the 1947 amendment) or to the Republic of Ireland (as in the 1959, 1960, 1973 and 1975 amendments), did not concede any territorial claim and followed the form laid down in section 1 of the Éire (Confirmation of Agreements) Act 1938 or in section 1 of the Ireland Act 1949, respectively.

The other reason was the conflict in nomenclature inherent in the adoption of the Republic of Ireland Act, 1948 in Ireland, and the Ireland Act, 1949 in the UK. Ireland called itself 'Ireland' rather than 'the Republic of Ireland', which it regarded as a title applied by the UK for the purposes of UK domestic law under an Act which was simply recognising the *de facto* existence of Ireland as a republic outside the Commonwealth. From a UK perspective the continued use of the term Éire or Republic of Ireland made clear that it was dealing territorially with that part of the island of Ireland other than Northern Ireland.

[29] Enacted in United Kingdom domestic law as F.A.1960, s.42 and Sch.5. The 1960 Agreement immediately preceded the enactment of further UK dividend stripping legislation (s.28 Finance Act 1960). It sought to amend the 1926 Agreement for the provisions of s.28, and to avoid the need for further amending agreements for similar future provisions, as follows:

'Legislation enacted in either country at any time after the date of this Agreement [23 June 1960 – the Finance Act 1960 was enacted on 29 July 1960] and affecting in any way exemptions from income tax of that country of persons resident in that country shall … have the like effect on exemptions from that tax which persons enjoy as not resident in that country but resident in the other of the two countries, and the enactment of such legislation shall not affect the continuance in force of the Agreement of 1926, as amended by the Agreements of … '.

The subsequent decision of the House of Lords in *Collco* (above n. 28) meant that, at least in the UK, this provision was not necessary.

[30] Enacted in United Kingdom domestic law as F.A. 1973, s.42 and Sch.17 and by F. (No.2) A. 1975, s.65 and Sch.11. The 1973 amendment was required in order to take account of the switch to unified tax for individuals in the United Kingdom from 1973/74 onwards and the 1975 amendment amended the 1973 agreement so that it had effect as respects dividends paid on or after 6 April 1975 and not later than 5 April 1976.

DOES IT MATTER? THE 1926 AGREEMENT

Does any of this matter? What's in a name? Well, clearly in one sense it does matter and this is why the different usages have arisen. The question in the present context is whether there is or was any, and if so what, impact from a taxation viewpoint. In doing so we should distinguish between differences in the description of the governments and differences in the substantive provisions of the texts of the agreement itself.

Let us look first at the 1926 Agreement. Initially there was common ground, as described above, both in the description of the governments and in the text of the agreement itself. The 1926 Agreement provided that it was 'subject to confirmation by the British Parliament and by the Oireachtas of the Irish Free State and shall have effect only if and so long as legislation confirming the Agreement is in force both in Great Britain and Northern Ireland and in the Irish Free State.'[31] The appropriate legislation was duly passed in both countries.[32]

What was the effect of the adoption of a new constitution in the Irish Free State in 1937? The 1926 agreement (as amended in 1928) continued in force because the legislation confirming the agreement remained in place both in Irish and in UK domestic law. The claim in Article 2 of the new constitution that the national territory of Ireland consisted of the whole island of Ireland etc had no impact on the substantive provisions of the text of the 1926 Agreement (as amended in 1928). These provisions covered the position where the profits or gains etc arose in the Irish Free State (or in Great Britain or Northern Ireland, as the case might be) and the claimant was resident in Great Britain or Northern Ireland and not resident in the Irish Free State (or vice versa). The text of the agreement in these terms continued in force in the domestic law of both countries and these terms, it is submitted, retained the meaning which they had when the 1926 Agreement was signed.[33] By a similar reasoning the Ireland Act 1949 had no effect on the position. In neither case would a person residing in Northern Ireland come within the definition

[31] Article 8. Incidentally, the 1926 agreement was signed for the British Government by Winston Churchill as Chancellor of the Exchequer.

[32] The agreement was enacted in UK domestic law as Section 23 of the Finance Act 1926 and later consolidated as Section 349 and Schedule 18 of the Income Tax Act 1952 (subsequently Section 513 and schedule 12 of the Taxes Act 1970). The umbrella enabling provisions in relation to comprehensive double taxation agreements (now in Section 788 Taxes Act 1988) were not enacted until 1945 (as section 51 of the Finance (No.2) Act 1945). The agreement was enacted in Irish domestic law by section 2 and Schedule I, Finance Act 1926 and later consolidated as section 355 and Schedule 6, Income Tax Act 1967. The Irish umbrella enabling provisions in relation to comprehensive double taxation agreements (now in section 826 Taxes Consolidation Act 1997) were not enacted until 1958 (as section 44, Finance Act 1958).

[33] The claim by Ireland to the area of Northern Ireland remained a claim only.

of resident of the Irish Free State by reason of the territorial claim to Northern Ireland because the Irish tax laws did not extend to Northern Ireland.

We then come to the amending agreements of 1947, 1959, 1960, 1973 and 1975. These agreements, while adopting different descriptions of the two governments in the rival versions,[34] were nevertheless acted upon by both governments and substantively did no more than limit in particular respects the exemptions in the 1926 Agreement which thus stood intact (subject to these limitations) in its original principal terms. Indeed one of the purposes of the 1959 and 1960 amending Agreements was to confirm that the 1926 Agreement (as amended by the 1928 and 1947 Agreements) continued in force notwithstanding the limitations imposed by the earlier amending agreements.[35]

So the 1926 Agreement and its amendments seems to have occasioned no difficulty either in theory or in practice. This was, in summary, because despite the differing descriptions of the governments in later amending agreements both governments were content to enact the amending agreements in their domestic law. More importantly, there were no differences in the *text* of the agreements, and the original text of the 1926 agreement was maintained, with the agreed amendments, in the domestic law of both countries throughout the period until repealed. Finally, despite the territorial claim, Ireland made no claim that its tax laws extended to Northern Ireland.

The 1926 agreement was finally removed from the statute books in Ireland in 1977[36] after ratification of the 1976 Convention.[37] In the United Kingdom the repeal of the domestic legislation giving effect to the 1926 agreement, and amending agreements, was effected by section 49, Finance Act 1976. This repeal was conditional upon the Queen in Council declaring, in the year 1976, that arrangements under section 497, Taxes Act 1970 (now section 788 Taxes Act 1988) between the United Kingdom and the Government of the Republic of Ireland should have effect.[38] The repeal was to come into effect at the same time as the Order in Council thus avoiding a gap period; the entry into force provisions of the 1976

[34] Neither the 1926 agreement nor the amending agreements of 1947, 1959 or 1960 make any reference to the number of copies signed. The 1973 and 1975 amending agreements were described as being signed in two originals.

[35] See Article 1(2) of the 1959 agreement and the recitals to the 1960 agreement.

[36] Finance Act 1977, section 54 and Sch 2 Part 1.

[37] However, the Finance Act 1926, which had originally implemented the 1926 agreement in Irish law, had included provisions to remove from the remittance basis of taxation 'property situate and profits or gains arising in Great Britain or Northern Ireland'. (The equivalent capital gains provisions limit the remittance basis to 'assets situated outside the State and the United Kingdom'). These provisions continued in force notwithstanding the repeal of the legislation incorporating the 1926 agreement into domestic law and are now contained in section 73 TCA 1977 for income tax and section 29 TCA 1977 for capital gains tax.

[38] The Order in Council was made on 15 December, 1976.

agreement (article 28) also contained transitional provisions clarifying the interaction of the old and new provisions.[39]

DOES IT MATTER? THE 1976 CONVENTION AND ITS FIRST TWO PROTOCOLS[40]

Let us now turn to the 1976 Convention which is quite different in form from the 1926 Agreement being a treaty drafted along the lines of the OECD Model. It therefore does not allocate taxing rights by reference solely to residence (except in the case of Other Income) but allocates them according to the nature of the income between source country and residence country with provision for credit relief where the income may be taxed in both countries. The Convention takes effect in each country under the respective enabling provisions relating to double taxation arrangements[41] and not by specific and separate enactment in domestic law.

The differing descriptions which the governments give themselves cause no difficulty because both governments were content to act to give effect to the Convention. However because of the form which the Convention takes the definition of 'contracting state' assumes importance in terms of the operative provisions of the treaty itself and is not limited to describing the titles of the respective governments which are the parties to the agreement. For example, to qualify for treaty relief a person must be 'a resident of a contracting state.'

In the United Kingdom text of the 1976 Convention article 3(1)(f) states that: 'the terms "a Contracting State" and "the other Contracting State"

[39] As in Ireland (n.37), the United Kingdom provisions giving effect to the 1926 agreement had excluded the remittance basis of taxation for tax chargeable under Case IV or Case V in relation to 'property situate and profits or gains arising in the Republic of Ireland'. This exclusion likewise did not form part of the provisions repealed but was preserved by the Finance Act 1976 and is now to be found in section 68 Taxes Act 1988. The original provision was in Part II of Schedule 2, Finance Act, 1926. On consolidation in 1952 this became para.2(1) of Part III of Schedule 18, Income Tax Act 1952. S.49(3) Finance Act 1976 stated that para.2 was to continue in force by virtue of that section and not, as previously, by virtue of s.513 of the Income Tax Act 1952, which gave effect to Schedule 18. The provision was consolidated in 1970, and again in 1988, and now appears in section 68 Taxes Act 1988.

[40] There is also an inheritance and gift treaty. This treaty was 'Done in two originals at London' on 7 December 1977, and took effect in the UK under the Double Taxation Relief (Taxes on Estates of Deceased Persons and Inheritances and on Gifts)(Republic of Ireland) Order S.I.1978 No.1107 and in Ireland under S.I. 1978 No. 279. In the UK text, as it appears in the statutory instrument, the agreement is expressed to be between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Republic of Ireland. The Contracting States are defined as the United Kingdom and the Republic of Ireland. In the Irish text the agreement is expressed to be between the Government of Ireland and the Government of the United Kingdom. The Contracting States are defined as Ireland and the United Kingdom. Similar issues to those discussed below therefore arise in relation to that treaty but they are not discussed separately in this paper.

[41] See n.32 above.

mean "the United Kingdom" or 'the Republic of Ireland' as the context requires;' while in the Irish text the terms are defined to mean 'Ireland' or 'the United Kingdom' as the context requires. However in neither text are the terms Ireland, Republic of Ireland or United Kingdom themselves defined. Article 3(1) of the Convention (in both versions) simply states: 'In this Convention, unless the context otherwise requires: (a) the term "United Kingdom" includes any area outside the territorial sea which in accordance with international law has been or may hereafter be designated, under the laws of the United Kingdom concerning the Continental Shelf, as an area within which the rights of the United Kingdom with respect to the seabed and subsoil and their natural resources may be exercised.'[42] Likewise, *mutatis mutandis* and with the substitution of 'territorial waters' for 'territorial sea', in relation to 'the Republic of Ireland' in the United Kingdom text and to 'Ireland' in the Irish text.[43] These terms, i.e. Ireland, Republic of Ireland and the United Kingdom, being themselves undefined, are thus, in the application of the convention by a contracting state, to have (unless the context otherwise requires) the meaning which they have 'under the laws of that contracting state relating to the taxes which are the subject of this convention.'

In the United Kingdom text this would result in the term 'the United Kingdom' being interpreted, in the United Kingdom, to include Northern Ireland and the term 'the Republic of Ireland' being interpreted, under section 1 of the Ireland Act 1949 (there being no specific tax definition), to exclude Northern Ireland.

The authority for the United Kingdom interpretation was to be found in the Royal and Parliamentary Titles Act 1927 which provided that the United Kingdom Parliament should thereafter be known as the 'Parliament of the United Kingdom of Great Britain and Northern Ireland; and accordingly, the present Parliament shall be known as the Thirty- fourth Parliament of the United Kingdom of Great Britain and Northern Ireland, instead of the Thirty-fourth Parliament of the United Kingdom of Great

[42] Contrast this with normal United Kingdom treaty practice which is to state that : 'the term "United Kingdom" *means Great Britain and Northern Ireland*, including any area outside the territorial sea ……etc.' [emphasis added]

[43] Normal treaty practice in Ireland is to not to define 'Ireland' save in terms to include the Continental Shelf 'the term "Ireland" includes any area adjacent to the territorial waters of Ireland which by Irish legislation concerning the Continental Shelf, and in accordance with international law, has been or may hereafter be designated as an area within which the rights of Ireland with respect to the sea bed and sub-soil and their natural resources may be exercised.' However, the former Ireland/US treaty is the sole exception in this respect. This was signed in Dublin on 13 September 1949, a mere five months after entry into force of the Republic of Ireland Act 1948, by P McGilligan and Sean MacBride, respectively ministers for Finance and External Affairs in the Inter-Party government led by John A. Costello. This provided 'the term "Ireland" means the Republic of Ireland and the term "Irish" has a corresponding meaning.'

Britain and Ireland.'[44] It also provided that in every subsequent Act passed and public document issued the expression 'United Kingdom' was, unless the context otherwise required, to mean 'Great Britain and Northern Ireland.'[45] These provisions are now subsumed into section 5 and Schedule 1, Interpretation Act, 1978. The Interpretation Act 1978 contains definitions of 'British Islands', 'England', 'Wales' and 'United Kingdom' but not of 'Great Britain', 'Ireland', 'Northern Ireland' or 'Scotland', though there is a definition of 'Northern Ireland legislation'. Presumably it was felt that the Government of Ireland Act 1920 established for all purposes the territorial extent of Northern Ireland.

Notwithstanding that in the Irish version of the 1976 Convention, 'Ireland' might seem to include Northern Ireland, and conversely 'the United Kingdom' to exclude Northern Ireland, given the 1937 Constitution, Article 3 of the Constitution as noted above clarifies that laws enacted by the Irish Parliament do not have application to Northern Ireland. In bringing the treaty into force by Government order it seems clear that the 'force of law' of the treaty is limited to the same scope as the general legislation, and thus is confined in application to the *de facto* area of Ireland (i.e. Ireland excluding Northern Ireland). The Supreme Court[46] has held that the correct interpretation of Article 3 of the Constitution is to prohibit the enactment in Ireland of laws applicable in Northern Ireland.

In any event, under Article 3(2) it is the meaning 'under the laws .... relating to the taxes which are the subject of this Convention' which must first be sought and only if there is no such meaning would one then look to the general law. So because in Ireland, tax legislation, like all legislation, applies only to Ireland excluding Northern Ireland,[47] there is no question of extra-territorial application of these taxes.[48]

[44] S.2(1).
[45] S.2(2). Note that by s.38 Finance Act 1973 (now consolidated as s.830 Taxes Act 1988 and s.276 Taxation of Chargeable Gains Act 1992) the territorial sea of the United Kingdom was for tax purposes deemed thereafter to be part of the United Kingdom.
[46] *McGimpsey v Ireland* [1990] 1 IR 110.
[47] Note that in relation to the powers of the Northern Ireland Parliament s.21(1) of the Government of Ireland Act, 1920, provided that the Parliament of Northern Ireland has no power to impose or charge 'customs duties, excise duties.....and excess profits duty, corporation profits tax, and any other tax on profits, and (except to the extent hereinafter mentioned) income tax (including super-tax) or any tax substantially similar in character as any of those duties or taxes.....'.
[48] Note the approach in other UK treaties where there has been a question as the extent of the other country's territory which is covered by the treaty. For example, the treaty with Germany (Double Taxation Relief (Taxes on Income)(Germany) Order, S.I.1967 No.25) states in Article II(1)(b) that 'the term "the Federal Republic" means the territory in which the Basic Law for the Federal Republic is in force;'. Thus on the reunification of Germany, when the Basic Law entered into force also in the states comprising the former East Germany or German Democratic Republic, the 1967 treaty thereafter applied to that territory also, without the

The only reference to 'Ireland' in the United Kingdom version of the Convention is in the definition of 'nationals' where in the case of the Republic of Ireland this term is defined to mean *inter alia* 'all citizens of Ireland'.[49] Here the use of Ireland was inescapable because Ireland grants citizenship as citizenship of Ireland and not of 'the Republic of Ireland'. Citizenship of the Republic of Ireland does not exist and, since the description of citizenship is entirely a matter of Irish law as to who are the citizens of that country and how their citizenship is described, it was therefore necessary to use the term 'citizens of Ireland' in the definition of nationals. The definition of 'nationals' in relation to the United Kingdom is based, in the case of individuals, on the language used in the relevant British Nationality Act, hence the particular wording of the definition in Article 3(1)(c)(i). This follows usual United Kingdom treaty practice.

THE ROLE OF THE BELFAST AGREEMENT

We now come to the Belfast Agreement and the 1998 Protocol. The Belfast Agreement [50] is described as 'Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of Ireland.'[51] The agreement reached in the multi-party talks is attached to it as Annex 1. In the agreement and in Annex 1 there are references to the British and Irish governments, to Northern Ireland, to North/South co-operation (and a North/South Ministerial Council), to a 'sovereign united Ireland' and to 'the island of Ireland.' There seems to be no reference in the text of the agreement to 'Ireland'. The agreement reached in the multi-party talks does however address the question of Ireland's territorial claim to Northern Ireland and Annex B of the section of the agreement on Constitutional Issues sets out Irish Government draft legislation to amend the constitution. The claim to Northern Ireland was to be removed from the Irish constitution through the substitution of Article 2[52] by a new Article 2, which was to read:

need for any amendment or renegotiation. Another example is the UK treaty with Israel (Double Taxation Relief (Taxes on Income)(Israel) Order 1963 S.I. No.616. Article II(1) states: 'the term "Israel" means the territory in which the Government of Israel levy taxation.' Similarly, although the Irish treaties with Germany and Israel do not contain this type of definitions, the treaty with the Czech Republic states 'the term 'Czech Republic' means the territory of the Czech Republic over which, under Czech legislation and in accordance with international law, the sovereign rights of the Czech Republic may be exercised'.

[49] Article 3 (1) (c)(i).
[50] Cm.3883.
[51] *Ibid.* The agreement is described as 'Done in two originals' –but in this case, like the 1998 Protocol, the UK and Irish texts are identical.
[52] See p.181 above.

> It is the entitlement and birthright of every person born in the island of Ireland which includes its islands and seas, to be part of the Irish nation. That is also the entitlement of all persons otherwise qualified in accordance with law to be citizens of Ireland. Furthermore, the Irish nation cherishes its special affinity with people of Irish ancestry living abroad who share its cultural identity and heritage.

In addition, there was to be added to Article 8 a statement that:

> The state may exercise extra territorial jurisdiction in accordance with the generally recognised principles of international law.[53]

In the United Kingdom the Government of Ireland Act 1920 was to be repealed.[54]

In Ireland, a referendum has inserted a new paragraph 7 into Article 29 of the Constitution (dealing with International Relations), providing for the adoption of the agreement and facilitating the cross border bodies in the following form:

1. The State may consent to be bound by the British-Irish Agreement done at Belfast on the 10th day of April, 1998, hereinafter called the Agreement.
2. Any institution established by or under the Agreement may exercise the powers and functions thereby conferred on it in respect of all or any part of the island of Ireland notwithstanding any other provision of this Constitution conferring a like power or function on any person or any organ of State appointed under or created or established by or under this Constitution. Any power or function conferred on such an institution in relation to the settlement or resolution of disputes or controversies may be in addition to or in substitution for any like power or function conferred by this Constitution on any such person or organ of State as aforesaid.

The changes in Article 2 and 3 of the Irish constitution were provisionally adopted by the referendum and came into effect on 2 December 1999 when

[53] Article 3 was also to be amended to refer to the 'firm will of the Irish nation, in harmony and friendship, to unite all the people who share the territory of the island of Ireland, in all the diversity of their identities and traditions, recognising that the united Ireland shall be brought about only by peaceful means the consent of the majority of the people, democratically expressed, in both jurisdictions in the island. Until then, the laws enacted by the Parliament established by this Constitution shall have the like area and extent of application as the laws enacted by the Parliament that existed immediately before the coming into operation of this Constitution'.

[54] This was, incidentally, the reason for the enactment in the UK of the stamp duty provisions set out in F.A.1998 s.150. The Government of Ireland Act 1920 was to be repealed on a day to be appointed by section 2 of the Northern Ireland Act 1998(c.47) and that day was appointed when the Assembly came into being.

a declaration was made in accordance with the Agreement substituting the new constitutional provisions.

These steps may be said to have removed the territorial issue as a factor supporting different usage. They also diminished the ground on which the United Kingdom could insist on the use of the term 'Republic of Ireland' because the Belfast Agreement is itself described as being with the Government of Ireland, which indeed is also the wording used in the Irish version of the 1976 Convention. Although United Kingdom domestic usage would not then be in accordance with the Ireland Act 1949 the term was here being employed in a treaty: the fact that the treaty took effect in domestic law by way of an Order in Council promulgated in a Statutory Instrument did not require that the treaty itself had to use the term Republic of Ireland, and furthermore Section 1 of the Ireland Act 1949 is permissive rather than mandatory. Nevertheless, at no point in the text itself of the Belfast Agreement is the expression 'Ireland' used. This abstinence would seem to be because of the need for the expression to be defined if confusion was to be avoided. This is a different approach from the 1998 protocol, where the expression 'Ireland' *is* used, and to which we now turn.

DOES IT MATTER? THE 1998 PROTOCOL

The description of the two governments in the 1998 Protocol as the Government of Great Britain and Northern Ireland and the Government of Ireland respectively does not of itself give rise to any difficulty, because the Protocol was amending the 1976 Convention, and both governments have acted upon it.

The references in the text of the Protocol to 'a contracting state', 'the other contracting state', and 'a resident of a contracting state' etc. cause no difficulty either because these expressions are already defined in the 1976 Convention.[55] However, as mentioned above,[56] there are three instances in the text of the Protocol where it has been necessary to make specific reference by name to one country or the other, as opposed to a reference to a contracting state. One instance is in the provision for entry into force[57] where the respective references are to 'the United Kingdom' and to 'Ireland'. The other two occasions are in the new dividend article[58] which refers specifically to the respective domestic legislative provisions in defining the term 'superannuation scheme' ('in the case of Ireland' or 'in the case

[55] Articles 3 and 4.
[56] p.178 and nn.9 and 10.
[57] Article VII.
[58] Article II of the Protocol deleting article 11 of the Convention and replacing it by a new Article 11.

of the United Kingdom' as the case might be) and in defining dividends (as a distribution 'under the laws of Ireland' or 'under the laws of the United Kingdom' as the case might be).

What, if any, difficulties arise from these references? In terms of the interpretation in Ireland of the 1998 protocol the analysis is similar to that in relation to the 1976 Convention itself, since the amendments follow wording which was already used in the Irish version of the Convention. It is in the United Kingdom that any difficulties may arise because, as discussed above, Ireland could be understood to describe the whole island of Ireland.[59] Thus one can appreciate that the use of references to Ireland in the amending Protocol may well have given difficulties for the United Kingdom, particularly since the United Kingdom text of the original Convention which is being amended contains no reference to Ireland. Is Ireland then an undefined term to be interpreted according to domestic law? If so then confusion seems to follow because then Ireland would seem to refer to the whole island.[60]

The counter-argument, which would avoid this confusion, would be that the context requires some other meaning to be given. The Protocol is amending the 1976 Convention. In the context of the Convention the references to 'Ireland' and 'Irish' should be construed, in the light of the references in the Convention to the Republic of Ireland, as having the same meaning as that term in the Convention. It is clear that the definition of the term 'Contracting State' when used in the Protocol is the definition given by the 1976 Convention which refers to 'the United Kingdom' and 'the Republic of Ireland.' In the United Kingdom at least, Article 3(2) would have effect so as to give 'United Kingdom' the meaning 'Great Britain and Northern Ireland' and so, in any context where a distinction was being made between the United Kingdom and Ireland, 'Ireland' would have to be given a meaning which would exclude Northern Ireland in order to avoid overlapping provisions.

It is furthermore understood that the Secretary of State for Foreign and Commonwealth Affairs could be asked to issue a certificate to the effect that the country formerly known in the United Kingdom as the Republic of Ireland was now known simply as 'Ireland', such a certificate from the Secretary of State as to the international status of a territory being regarded as binding on the courts.

Moreover even if Ireland might nevertheless be said to mean the whole island it is difficult to see how that would affect the three references to it in

[59] See for example the Government of Ireland Act, 1920, above. Although that Act has now been repealed (n.54 above) the usage did not derive from that Act but rather the Act was itself simply reflecting or illustrating the general understanding. This, it is suggested, is the reason why the term 'Ireland' is never used in the text of the Belfast agreement.

[60] But not so as to include the Continental Shelf because that could only be included by express mention in the treaty which makes no mention at all of Ireland in the general definitions (article 3).

the third Protocol which are either specific references to internal tax law or to the entry into force which relates to tax law generally and which cannot therefore include Northern Ireland. On this basis it seems reasonable to conclude that, in the words of the Inland Revenue Press Release:[61] 'The term 'Ireland' as used in the Protocol has the same meaning as 'Republic of Ireland' in the Convention and previous Protocols.' However one must caution that the press release is not itself admissible as an aid to interpreting the Convention.

CONCLUSIONS ON THE 1976 CONVENTION AND ITS PROTOCOLS

What conclusions can we draw in relation to the 1976 Convention and its first and second Protocols? As with the 1926 Agreement and its amending agreements the differences in nomenclature do not seem to have given rise to any difficulties so far in practice.

The differing descriptions of the two governments as parties to the 1976 Convention and to the first and second Protocols did not hinder the enactment of the respective treaty provisions into the respective domestic laws. Furthermore, because these descriptions did not form part of the operative treaty text they were not relevant for the interpretation of the treaty provisions.

In the case of a treaty, or indeed an intergovernmental agreement such as the agreement of 1926, the parties are the two states. In countries such as the UK and Ireland, being so-called duallist states, where treaties do not take direct effect but must be incorporated into domestic law by a further procedure, individual taxpayers acquire no rights under the treaty as such but rely on the provisions of the treaty as given effect in domestic law.

How have the two states applied and interpreted the treaty provisions as they appear in their domestic laws? Ireland has applied them as if the territory referred to as Ireland in its provisions is for tax purposes the same territory as that which the UK refers to as the Republic of Ireland. In particular, as stated above, Ireland does not purport to legislate for Northern Ireland and moreover accepts that in the context of the treaty the United Kingdom includes Northern Ireland.[62] Thus, for example, Ireland accepts that a person residing in Northern Ireland is a resident of the United Kingdom for the purposes of the treaty.

The United Kingdom text describes the Contracting States as the United Kingdom or the Republic of Ireland, as the context requires. The expression the Republic of Ireland takes its meaning from section 1(3) of the

[61] Above n.11.
[62] The latter is an inevitable consequence of the former Article 3 of the Irish constitution.

Ireland Act 1949[63] and thus excludes Northern Ireland, while the term United Kingdom includes Northern Ireland.[64] Thus the meaning of the United Kingdom treaty text on the territorial question is unequivocal.

For these reasons there has in practice been no territorial issue in either country to date on the 1976 convention or on the first and second protocols despite or perhaps (in the case of the United Kingdom) because of the use of different wording in the respective texts.

We have described above[65] how even the term Republic of Ireland had a different meaning in the two states, the source of this potential confusion being the name assumed by the Irish state in the 1937 Constitution. Under that constitution, as the taoiseach pointed out in the debate on the introduction of The Republic of Ireland Act, 1948, the name of the state in the English language is Ireland while under section 2 of the Act 'the *description* of the State shall be the Republic of Ireland.'[66] This description was not to be limited to the twenty six counties but, like the name Ireland, was to be applied to the whole island. At the same time the United Kingdom was also adopting the term Republic of Ireland but the United Kingdom clearly understood it as referring only to the twenty six counties.[67] From an Irish viewpoint the two terms were synonymous, but not from a UK viewpoint.

Will the third protocol cause any difficulty? It is unlikely to do so in Ireland. The wording (i.e. the references to Ireland) is entirely consistent with the Irish text of the 1976 Convention and the first and second Protocols. No difficulty has arisen on those arrangements because, as already stated, Ireland does not purport to legislate for Northern Ireland and moreover accepts that in the context of the treaty the United Kingdom includes Northern Ireland. Furthermore the subsequent changes to the constitution have removed the territorial claim to Northern Ireland.

In the United Kingdom the position is less clear. The term Ireland as it appears in the Protocol is not defined. If it was to be given its United Kingdom domestic law meaning under article 3(2) then it would refer to the whole island, i.e. both the Republic of Ireland and Northern Ireland, causing confusion as to its effect. However the Protocol is simply

[63] See pp.182–3 above.
[64] Royal and Parliamentary Titles Act 1927 which is now repealed and succeeded by the Interpretation Act 1978. See text adjacent to n.45 on p.10.
[65] See pp.181–2 above.
[66] See the text above adjacent to n.19. Emphasis supplied.
[67] The position is slightly different in the world of international football. In rugby union football a single team, drawn from both sides of the border, is styled Ireland. This team, as Ireland, competes against England, Scotland, Wales and France in the Five (now Six – including Italy) Nations Rugby Union Championship. In association football the position is different. Two teams compete at international level, drawn from the respective sides of the border. The team drawn from the South is termed Republic of Ireland (and not Ireland), to distinguish it from the Northern Ireland soccer team (and the England , Scotland and Wales teams). One of the authors of the paper recalls Ray Houghton's goal for the Republic of Ireland team in an historic 1-0 win over England (not the United Kingdom) in Stuttgart in 1988!

amending the 1976 Convention. In the context of the Convention, which defines the contracting states in the United Kingdom text as the Republic of Ireland and the United Kingdom, the reference in the third protocol to Ireland should be taken as a reference to the Republic of Ireland and not to the whole of Ireland. To give it the latter meaning would be to take it out of context. It is probably on this basis that the Inland Revenue Press Release[68] is able to assert that: 'The term 'Ireland' as used in the Protocol has the same meaning as 'Republic of Ireland' in the Convention and previous Protocols.' What may be more problematical is how the contracting states should be described in the event of the negotiation of a completely new treaty, assuming that it is only to have one text. That however is currently a hypothetical question.

APPENDIX

The Descriptions of the Respective Governments

		Irish Version	UK Version
The 1926 Agreement			
Agreement made 14 April 1926			
	Between	The British Government	The British Government
	And	The Government of the Irish Free State	The Government of the Irish Free State
Agreements amending the 1926 Agreement			
Agreement made 25 April 1928		as above	as above
Agreement made 21 July 1947			
	Between	The Government of the United Kingdom	The United Kingdom Government
	And	The Government of Ireland	The Éire Government
Agreement made 4 April 1959			
	Between	The Government of the United Kingdom	The Government of the United Kingdom
	And	The Government of Ireland	The Government of the Republic of Ireland
Agreement made 23 June 1960		as above	as above

[68] See n.11 above.

		Irish Version	UK Version
Agreement made 2 May 1973			
	Between	as above	The Government of the United Kingdom of Great Britain and Northern Ireland
And		as above	The Government of the Republic of Ireland
Agreement made 3 June 1975		as above	as above
<u>The 1976 Convention</u>			
Double Taxation Convention made on 2 June 1976			
	Between	The Government of the United Kingdom	The Government of the United Kingdom of Great Britain and Northern Ireland
	And	The Government of Ireland	The Government of the Republic of Ireland
First Protocol dated 28 October 1976		as above	as above
Second Protocol dated 7 November 1994		as above	as above
Third Protocol dated 4 November 1998			
	Between	The Government of the United Kingdom of Great Britain and Northern Ireland	The Government of the United Kingdom of Great Britain and Northern Ireland
	And	The Government of Ireland	The Government of Ireland

Part 3

Deep History

9

John Lackland: A Fiscal Re-evaluation

JANE FRECKNALL HUGHES* AND LYNNE OATS

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ABSTRACT

IN RECENT YEARS there has been a noticeable academic movement towards re-evaluating aspects of the reign of King John – though it is fair to say that there has never been complete agreement among historians as to how the events of his reign or his personal actions should be interpreted.

The object of this paper is to present a re-evaluation of John's reign from a fiscal perspective. The aim is to see John in the context of his Angevin predecessors, Henry II and Richard I, and to develop an appreciation of his fiscal measures (with reference where possible to original source materials), particularly in terms of their innovation. From the standpoint of taxation in England, John appears as a significant influence in moving away from feudal systems towards measures which seem more modern. However, the question is not often asked as to why these important steps were taken, hence the paper will also examine why it was necessary for John to enact new measures and the influence they had on events leading up to the Magna Carta.

JOHN LACKLAND: AN ATTEMPT AT FISCAL RE-EVALUATION

1. Introduction

The purpose of this paper is to collate and review details of the revenue raising measures employed in the reign of King John. It does not aim to calculate how much revenue was raised (this has already been done – see Barratt, 1996), but

* The authors would like to thank Mr. Ronald Frecknall for his invaluable assistance with the first draft of this paper.

to examine the means themselves, particularly how they exploited measures introduced already by Henry II or Richard I, and what they added in terms of novelty. The paper begins by looking at John in context, and then moving on to examine individually the ordinary and extraordinary ways in which he raised revenue. The aim here is to 'get the story straight'. With this objective, the facts reported by secondary sources as gleaned from contemporary chroniclers and various official documents have been accepted as they stand. Though they have been referred to on occasion, a complete re-evaluation of contemporary sources will be left for another paper. The paper concludes by looking at the Magna Carta clauses from the perspective of John's fiscal measures.

2. John in the Context of the Succession

The accession of John to the throne of England would have been regarded as an unlikely possibility at the time of his birth. He was the eighth (and last) child and fourth son[1] of Henry II and his wife Eleanor of Aquitaine (Weir, 2002: 65). All his sisters survived into adulthood, as did three of his brothers – 'Young' Henry (1155–1183), Richard (1157–1199) and Geoffrey (1158–1186). At the date of John's birth there was no shortage of male heirs to the English crown or potential for others, as his older brothers all married. However, the family fortunes changed considerably. 'Young' Henry's son was born and died in 1177 and 'Young' Henry himself died in 1183. Richard left no legitimate issue, though he had two illegitimate sons (Weir, 2002: 67). Geoffrey died in 1186, while Henry II was still alive, though he left a son, Arthur, born posthumously in 1187. In addition all Henry's daughters married and produced offspring. Although, with the benefit of hindsight, John's accession seems reasonably assured, at the time it must have been much less so. If present day accession principles of primogeniture had applied, Geoffrey's son Arthur would have succeeded Richard, who indeed designated him at one point as his heir (see Gillingham, 1999: 136, 227). Illegitimacy was not in itself a bar to succession (viz. William the Conqueror), nor was a claim through the distaff line. Henry II was a son of Henry I's daughter, Matilda, who herself had fought for the crown and lost it to her cousin Stephen, the son of Henry I's sister Adela. Henry II also had some twelve illegitimate children (Weir, 2002: 65), with three sons (Geoffrey, William and Hugh) occupying public offices under Richard and John. However, while there was a ruler's legitimate son and grandson surviving,

[1] Weir (2002: 63) refers to the possibility that Henry and Eleanor had a son called Philip, born between 1158 and 1162, who died young, based on the claims of the English antiquarian, John Speed, in his *History of Great Britain* of 1611. She comments that there is no contemporary evidence for his existence, and that Speed may have confused him with Richard I's illegitimate son Philip. As John was not born until 1166, this brother, if he existed, would likely have been dead before John's birth.

other claims must have seemed inferior. Arthur's claim (through his father Geoffrey) was not as clear then as it might seem now to us, as primogeniture succession was not predominant, and Arthur was Duke of Brittany in his own right through his mother, Constance of Brittany. Given the nature of Henry II's realm, it was not necessarily the case that one son as sole ruler would inherit the entirety. Henry may have imagined a loose federation of states governed by his sons. He had tinkered considerably with the lands he governed, first bestowing them on a particular son, and then changing his mind. Arthur presented a real enough threat to John, and the allegations that John had Arthur murdered around 1204 seem largely accepted (Turner, 1994: 121).

John lived through tumultuous years, fighting both on behalf of and against his father and his brother Richard, and against the French, a perpetual enemy, gaining a reputation for treachery and scheming (Gillingham, 1999: 337). While it is not the aim of this paper to delve into John's psychological make-up, it is germane to comment that the years of being a 'spare' heir, for whom his father found it difficult to provide (hence the nickname 'Lackland'), of being involved in family feuds and of simply being there and surviving, left their marks. John seems nothing if not a keen observer. He saw first hand many of the measures his father introduced together with all that was done in Richard's reign, having the unusual experience of day-to-day living in close proximity to two kings. From his own personal lack of resources and from observing the measures implemented under Richard, especially to collect the ransom needed to gain Richard's release from captivity on his return from the Third Crusade, it is likely that he would appreciate the requirement to have ready money, not just for his personal needs, but for the State, such that business should not be done always on an ad hoc or emergency footing.

3. John in the Context of Twelfth Century Revenues

Both John and Richard had great need of increased revenues. During the twelfth century, income from all sources was becoming insufficient to keep up with developments or incidents for which money was needed (Turner, 1999: 87ff; Mitchell, 1914: 2). The machinery of government developed greatly, especially under Henry II, requiring more paid officials; constant wars needed funds, either in repressing rebellions or fighting the French, the latter being endemic after the accession of Philip Augustus in 1180; the Third Crusade led by Richard I was immensely expensive, as was the ransom needed to liberate him from the clutches of Duke Leopold V of Austria; and inflation was increasing in this period, especially from about 1180. The reasons for this latter phenomenon are difficult to pin down precisely, but a significant contributing factor is the increase in the currency supply (silver) coming to England from new mines in eastern Germany through favourable

trade in wool and grain with Germany and the Low Countries (Turner, 1999: 89). It would cost John two shillings a day to hire a mercenary, whereas it would have cost his father eight pence (Warren, 1997: 145). Barratt (1996) analyses inflation adjusted revenues for the reign of John, and concludes that real income was in fact in decline until 1204, but increased after 1208, especially in 1211–12. Thus, even after allowing for the inflationary pressures, John tapped into revenue that was far greater than that available to the previous generation. The income only declined in 1214 and subsequently as a result of baronial opposition (Harris, 1964). Barratt (1996) concludes that John, certainly in the early years of his reign, merely continued policies and measures put in place by Richard. It was not until after the loss of Normandy in 1204, that the use of extraordinary tax became linked to dynastic purposes.

The importance of the increased availability of physical cash, and the transition to a cash economy in the twelfth century is greatly underestimated in terms of taxes and revenue raising. Henry II and his sons all sought to increase revenues, both from ordinary sources and from taxes. It was a continuous process, but by John's time had reached such a pitch that the concept and character of taxation had changed completely. Turner (1994: 87) maintains that John followed his brother in organizing a war economy. This may be true, but an effect of this was John's perceived need of regular income from all classes of subjects to support government, and in this lies the transition from the feudal to the modern fiscal state. This was a period of transition which Ormrod (1999: 38) describes as a change from a domain state to a tax based state which 'reflected the monarchy's perception of the gradual shift in the nature and exploitable resources of the English economy'. There was a clear move towards the economic foundation of the state as an entity separate from its ruler (Swanson, 1999: 100). Revenues regularly derived from lands and possessions under a ruler's personal control were not enough to sustain him and all that he needed to do in his capacity as ruler. This can be seen by looking at the income raised by the Angevin rulers, especially by John.

This fitted in very much with the expansionist spirit of the times. During the twelfth century 'governmental systems evolved to deal not merely with revenues, but with administration, law, and other aspects of rule' (Swanson, 1999: 99) which required written records to keep track of what was going on. Such records were also needed to keep track of cash and coin, as the economy moved away from transactions in kind to a cash economy. Moneys collected for various purposes had to be recorded. During John's reign much more detailed administrative and financial records were kept than ever before, many being dated. There are Pipe Rolls, Rolls of Letters Patent, Rolls of Letters Close, Rolls of Charters, and the Rolls of the King's Household (Curia Regis), all aimed at keeping track of different material (Warren, 1997:125–135). Such records, though not complete, provide a more objective

picture than the accounts of the contemporary chroniclers of John - the anonymous monks of Dunstable, Worcester and Tewkesbury, at Margam in Glamorgan and Waverley in Surrey, who were not actively involved in government, and whose views were coloured by the refusal of John to accept Stephen Langton, the Pope's appointee, as Archbishop of Canterbury, and his arrogation of Church revenues during the Interdict years of 1208–1214.

4. Income Under the Angevin Rulers

Most writers (e.g., Mitchell, 1914) consider that royal revenues in the twelfth century may be classed as ordinary and extraordinary. Mitchell (1914: 1) lists the ordinary revenues as follows:

- the county farm, a fixed sum paid by the sheriff for the privilege of farming the revenue of the royal demesne (domain) and the fines of the local courts;
- amercements imposed by the king's justices for violation of the law;
- the firma burgi, a lump sum paid by certain towns for the privilege of farming the town revenues;
- the income from feudal incidents, reliefs, marriages, wardships, escheats, etc.; and
- fines or oblations, payments to the king for such privileges as permission to marry a certain person, the custody of the lands of minors, the bringing of cases into the king's court, the delaying or expediting of a trial, and the grant and confirmation of charters. (Some of these overlapped with feudal incidents.);

To this list should be added:

- income from the royal forest.

This ordinary revenue was collected every year through the normal processes of government, and funded the ruler and his activities. If this ordinary revenue was insufficient, then additional contributions were sought. These additional contributions constituted extraordinary income – extraordinary because they were not levied every year, and often because they required new collection machinery being put in place to administer them. Mitchell (1914: 1 and 13) itemises these additional contributions:

- the aid on the knight's fee, called also scutage or shield money (see below for a detailed definition);
- carucage, which was levied on a unit of plough land, which was called a carucate;

- tallage, which was levied on the towns and demesne lands of the Crown;
- dona or auxilia, taken from Jewish or other money lenders, prelates and religious houses; and;
- the tax on moveables.

To this list should be added:

- the Church revenues which John received between the years 1208–1214.

5. Changes Introduced – Ordinary Revenues

(i) The County Farm

The ordinary revenue from shrieval (sheriffs') accounts is described by Barratt (2001: 637) as the 'backbone of English state finance'.

> ... Each sheriff on taking office agreed to pay a lump sum in respect of the revenues from the relevant lands in the shire, and himself collected the rents or let the manor out to farm. The difference was his profit.
>
> Warren, 1987: 151

There had been under Richard a discernable decline in the proportion of revenue from the county farms (Barratt, 2001). These produced only one third in 1193 of the sum which had been derived from that source in 1189, attributable to the impact of terrae datae (lands given away) on the county farm payment. At the time of Domesday, the king was the largest landholder (Ormrod, 1999: 22). Henry II had spent some thirty years cultivating demesne revenues, but under Richard I, royal manors were removed from the country farms, and not all of the alienated lands reappeared in the Pipe Rolls with separate farms. Under Richard, too, an experiment was undertaken, first in 1190 and then again during the period from 1194–1197, which entailed accounting separately for county escheats (Barratt, 2001).

The amount of money collected by farming revenues was probably not as much as might have been collected by direct estate management (Warren, 1987: 152), had this been possible, but it was more convenient, and the fixing of the amount of farms chargeable to sheriffs that occurred under Henry I meant that the amount due was certain and could be relied upon. Henry II, however, sought ways to increase the yield. After the reign of Stephen (following civil war between himself and his cousin Matilda), enquiries were undertaken to establish which lands exactly should be in the king's hand, though there does not seem to be any record of evictions or changes. A rental value was assigned to any 'misappropriated lands' and they were

separately accounted for at the Exchequer. However, since the manorial economy generally increased in the twelfth century, partly because of an increasing population and partly because of changed climatic conditions which favoured the growing of cereal crops (Warren, 1987: 152), farming county revenues became very profitable for the sheriff, but because the sums they paid for the privilege of farming were fixed, the Crown did not benefit. Ways were needed to tap into these excess profits. There was no reliable information as to the number of manors let, which was the basis of the original determination of the farms founded on Domesday records, as the sheriff himself controlled this process, and records had become outdated. Richard I auctioned off the sheriffdoms to the highest bidders at the beginning of his reign as a means of increasing revenue (Warren, 1987: 152), but the more usual way of obtaining increased revenue was as introduced by Henry II, namely that of charging the sheriff an increment in addition to the farms.[2] Harris (1964: 532–533) comments:

> One solution of this problem would have been to assess new farms of the shires, but this may have seemed too serious a breach of a customary assessment. Instead, a number of increments had been imposed. These were fixed annual payments of round-figure sums, accounted for separately from the farms.

Some increments were imposed in the early years of Henry II, and by 1199 eleven of 29 existing shrievalties were responsible for rendering increments (Harris, 1964: 533). The issue was to decide what was a reasonable level of increment, and presumably the sheriffs bargained with the Crown representatives to come to an agreed figure. An attempt was made under Hubert Walter in 1194 to enquire more exactly into the profitability of the royal demesne by commissioning itinerant justices to make enquiries (Warren, 1987: 153[3]). In the same year (Harris, 1964: 533) Richard imposed new increments totalling 1,070 marks[4] per year, in addition to, or possibly instead of fines for new sheriffs on entry to their offices. This represented a large increase in annual income, and was still in place when John acceded to the throne. Very high increments were charged under John, which were unpopular, as it led to sheriffs recouping the increments by extortion (Norgate, 1902: 214–215). Renunciation of increments was a concession made initially in Magna Carta, though it was omitted from re-issues of Magna Carta, and became contentious again under Henry III (Warren, 1987: 153, citing Maddicott, 1984: 28–30, 44–46).

[2] Warren (1997: 38) comments that in Richard's reign '[e]verything was for sale – privileges, lordships, earldoms, sheriffdoms, castles, towns, and suchlike'.

[3] Citing E.H.D. iii. 304–305.

[4] One mark was roughly two thirds of one English pound sterling, which was worth in turn twenty shillings.

The idea of an increment to tap into excess profits was very clever, and in line with current thinking in other areas (see under scutage later). It was a separate amount, assessed in a different way from the farms themselves, and seemed to be negotiable, at least to some extent. If the farms themselves had been re-assessed, then increases in amounts required might have led to sheriffs refusing to pay the entire farm itself. However, if it seemed that the king wanted too much by way of increment, the argument would be confined to this figure: the sheriff would have no reason not to pay the farm itself. Also an increment could be varied, and the possibility existed for this amount to be rebated. There is a record[5] that John pardoned an increment due from William Briwerre at William's request when he received the office of sheriff of Hampshire in 1200. There was always a fallback position, namely the customary amount of the farm itself, which was not contentious as it had been in existence for so very long.

However, in 1204 (Harris, 1964: 532), John began an experiment designed to increase his revenues from the English shrievalties. Many existing sheriffs were dismissed, and were succeeded by individuals called baillivi, who were required to account as custodians (instead of as farmers) for a variable amount over and above the standard farm, often referred to as a profit or profits (proficuum). This meant that the custodian had to account for his income and expenditure on an item by item basis. This seems to have applied to this element only: income and expenditure relating to the farm itself remained as before. Rendering account on an item by item basis was customary in the case of the administration of escheated lands and others temporarily in the king's hands. However, it remains unclear (Harris, 1964: 536) whether this profit was the same as an increment, or whether it was imposed instead of or in addition to it. Still less is there any evidence as to how profits themselves were assessed or how the custodianships actually worked. Harris (1964: 536) cites evidence to show that the baillivus was becoming 'a paid official with an expense account'. For example, in 1215, it was stated as right that Peter fitz Herbert should receive expenses for custody of Yorkshire and its royal castles, because he was answering for his profits[6].

Warren (1987, 153; 1997, 152–153) and Painter (1949: 120) consider that the experiment was a success in early years, but foundered from about 1208. However, Harris (1964: 538ff) disagrees, based on the Pipe Roll figures for 1209–1212. Yorkshire was placed under custody in 1209, which significantly increased income, and in 1209 the shrievalties of Cambridgeshire and Huntingdonshire, Devon, Essex and Hertfordshire, Hampshire, Lincolnshire, Rutland, Sussex and Warwickshire and Leicestershire also went over to the custodian system. All except Devon,

[5] Rot. Chart. p. 97; Pipe Roll 2 John, p.191.
[6] Rot. Litt. Claus. i.187b.

Essex and Hertfordshire and Rutland were returning to the system after a previous abandonment.

The picture emerges of a new system gradually being put in place, perhaps running in tandem with the old, but aiming to supersede it. This is not to deny that in some cases it failed to work or that it was unpopular. Some sheriffs made offers of money so as to be relieved from implementing the system, and sometimes the Exchequer failed to make sheriffs produce any accounts. Harris (1964: 538) cites the case of John Cornard, sheriff of Norfolk and Suffolk from 1205–1209, who consistently failed to produce any accounts, and of William de Montacute (of Dorset and Somerset), Roger fitz Adam (of Hampshire), and Hugh of Chacombe (of Warwickshire and Leicestershire) whose shrieval profits declined, such that they offered sums for the king's benevolence: they were removed from office. Decline in profits was not unusual. Harris (1964: 539) cites the case of William de Cahaignes, sheriff of Sussex who could not account for profit, because he had none. Indeed, owing to the inflation of the period, a sheriff often spent more than he collected – and the Exchequer might owe him money. This excess expenditure might be set against other debts he owed. Harris (1964: 536) also quotes the instances of Philip Mark and Engelard de Cigogne (early in Henry III's reign) successfully claiming quittance from Exchequer demands for profits on the grounds that they had spent all sums owed on repairs to castles or on accommodating the king and his followers. The system did require much more careful accounting and administration, and this, together with resentment in general at financial exactions, might account for the decline in income by 1214. By Michaelmas 1213 John had abandoned all the increments imposed not only by himself, but by Richard too. The Pipe Roll for 1214 only accounts for the old increments imposed by Henry II. Unpopular sheriffs, too, were being removed from northern counties (Harris, 1964: 540). However, the complexions of the farms had been radically altered by John's procedures. Whether he himself was responsible personally for thinking up these new ways to exact money is not known, but it could not have been done without his consent.

(ii) Other Ordinary Income (Amercements, Feudal Incidents, Oblations, etc.)

There is no systematic study to examine the income derived by other usual methods of revenue raising, though there are many references to this in various places, as increasing them was an on-going process for both Richard and John. After 1194, Richard increasingly exploited incidental revenue sources and fines relating to feudal incidents increased, a practice which John continued and took to extremes. Indeed under John they were 'imposed arbitrarily… and cynically developed… into a financial straightjacket intended to control the "loyalty" of the barons' (Barratt, 2001: 653).

Under the Normans, justice was a political issue, not a fiscal one, but the Angevins used justice as a revenue raising measure (Ormrod, 1999: 23). For instance, it was regarded as a privilege to have a case tried by the king, 'and men would offer as much as £100 for a royal audience' (Warren, 1997: 101), though John was content to accept as little as half a mark to judge even ordinary cases. However, he accepted 2000 marks from William Mowbray for justice when William de Stuteville claimed his barony – yet allowed the court to give judgement against Mowbray. Norgate (1902: 215) regards the system of justice under John as venal and corrupt, with one law for the rich and one for the poor. However, John took great personal interest in the system. He sat with his justices frequently, being on the move throughout the kingdom constantly with his household.

Subjects could – and did – purchase the king's favour (benevolentia) when they had crossed his will, to prevent distraint of property, or even expropriation, and issues of this nature are referred to in nearly all Pipe Rolls of the period (Warren, 1997: 177). A particular method used by John to control his tenants in this way was by keeping them, or encouraging them to become, indebted to the Crown. Warren (1997: 182) lists ways in which tenants might get into the Exchequer's toils. A man might commit a misdemeanour, such as by allowing an outlaw to escape, making a false claim, or putting a fish-weir in a river without the king's permission. He might be amerced for the offence (that is, fined in the modern sense of the word). Usually the amount of his amercement would be assessed by his peers in the king's court, but John would prefer to have the tenant buy his goodwill at exorbitant rates. Warren (1997: 182) cites the instance of Roger de Cressi marrying an heiress without the king's permission. John seized the lands of both until Roger came to make his peace. It cost him 1,200 marks and twelve palfreys to obtain the king's goodwill and regain his lands. As he was constantly moving about his kingdom, John could detect even small transgressions, and in 1210 Robert de Vaux was obliged to give the king five palfreys 'to keep quiet about the wife of Henry Pinel'[7], and to pay 750 marks for goodwill.

There were also the amercements – so great by the end of the century that the Exchequer had to abandon listing them (Warren: 1987: 159). Relief from fines for trivialities appears as Clause 20 in Magna Carta, so they were clearly felt to be an immense imposition. Anyone could be amerced for virtually any sort of mistake. Though comments are frequently made that amercements were usually for small amounts, it probably did not seem so to the payer.

John would also encourage his barons to pay more than they could possibly afford to gain, for example, for an heiress in marriage for a son, a wardship

[7] Warren, 1997: 182, citing Pipe Roll 12 John

of a minor's estate, the post of forest warden or castle constable, etc. Warren (1997: 182–183) cites some notable instances. John asked for 20,000 marks as the price for his former wife, Isabelle of Gloucester, which Geoffrey of Mandeville was prepared to pay. Although this behaviour may be put down to tenants' greed or ambition – and could be avoided – other issues could not. 'The king had the whip hand in the matter of succession dues' (Warren, 1997: 183), as there was no fixed amount the heir to land or title must pay to the king. Under Henry I £100 was a reasonable sum to pay (known as a relief), but John frequently demanded much more than this, 600 marks being commonly required. William Lacy in 1211 had to pay 7,000 marks, as he was out of favour at the time and William Stuteville and William FitzAlan had to pay 10,000 marks. Widows too had to pay between 100 and 300 marks for the right to their dowers, even if heiresses in their own right, with Hugh Bardolf's widow being charged 2,000 marks (Warren, 1997: 183).

Generally, these sums were more than tenants could pay at any one time, so they would become the king's debtors often for many years, which gave the king financial power over them, especially as he required their estates to be pledged formally to the Exchequer. A debtor who defaulted could have his lands forfeited (as did the Earl of Leicester between 1207 and 1215). John could thus use the pardoning of debt as a favour to friends or as a further harassment to his enemies. William Fortibus, for instance, was pardoned the relief owed for the inheritance of his mother, Hawise, countess of Aumale – who had actually been the king's mistress (Warren, 1997: 183). Many had recourse to Jewish money lenders – but this was not an escape. There was the interest to pay, and if a money lender died, the Crown was automatically heir, and took over cash, chattels and credit notes, so it was perfectly possible for an individual to end up with his debt back in the king's hands – especially as the king could ask for tallage at any time from the Jews.

John seemed to use these powers to cripple individuals financially simply because they were powerful, or he had become suspicious of them. William de Briouze had flourished under John, but died in exile in 1211 after being driven from his lands and from the country by John's ill will. His wife and son died in one of John's prisons, starved to death, despite an offer of a ransom of 40,000 marks. Warren (1997: 185) comments that every chronicle of the period contains a reference to this story, so it must have caused a very deep impression at the time. The reason for John's hostility to the de Briouze family is not really known, though the chronicler Roger of Wendover attributes it to William's wife's comments, when royal messengers in 1208 demanded hostages from her husband. (This was a common device by John to ensure tenants' loyalty). She refused, referring to Arthur's fate. John alleged it was because of William defaulting on money he had promised for his lordship of Limerick. One of John's problems in regard to loyalty was that his tenants frequently held lands and titles in France, for

which homage to Philip Augustus might be required. In the ever-changing times with constant switches between peace and hostility, it was difficult to know where one stood – or should stand.

(iii) The Royal Forest

The royal forest was always regarded as special. The forest comprised areas of land reserved for the king's hunting and other benefits. For example, the cutting of timber and the gathering of firewood were heavily restricted, as was the making of clearings (assarts). Pigs could be sent in to forage for acorns only under supervision and in specified weeks, and even taking a dog into the forest was subject to law about how it should be restrained and how its forefeet should be clipped. Any breach of these regulations was regarded as a serious offence. The forest law was imposed in addition to any other existing laws on those areas designated as forest. Parts of many shires and the whole of some counties were under forest law, and the 'additional law (was) of a harshly restrictive and punitive kind administered in special courts' (Warren, 1997: 160). There was a great deal of uncertainty as to which was forest domain, and as to the laws that applied to it, especially following the reign of Stephen. Henry II, probably about 1166, made his first assize, which clarified the rules (Warren, 1997: 162). The area of forest was probably greatly expanded in the latter half of the twelfth century. Although this may have been because the king loved hunting (yet there were areas he never visited), the reason could have been economic, as there was revenue at stake. There was income for the agisting of pigs, pasturing of cattle, harvesting of timber, and from the various fines and amercements, and from the sale of privileges and exemptions. A forest eyre (itinerant court dealing with forestry matters) brought in on average £2,000, but one in 1212 created debts on the Pipe Roll of £5,000, and a particularly savage one under Henry II in 1175 brought in £12,000. In addition the forest provided produce for the royal household and table (Warren, 1997: 162–163). However, there was demand continually for developing the land, and both Richard and John accepted proffers for disafforestment, and one of the demands of 1215 was that the forest be reduced to the boundaries that existed at Henry I's coronation.

There are many stories of venality and harassment in respect of the enforcement of forest law. That the office of forester was a rich one is proved by John's chief forester lending the king 3,350 marks from his personal fortune against future forest revenues (Warren, 1997: 163). The author of the *Dialogus de Scacarrio*,[8] though a royal treasurer, disapproved of forest law because it rested on the arbitrary will of the king, not on common law. Some reform of the forest law at least is suggested by the appearance of officials

[8] This work was written by Henry II's treasurer, Richard FitzNeal.

called verderers, who received no emoluments or perquisites, who were elected in the shire courts, and without whose investigation and testimony no one could be effectively prosecuted before a forest eyre (Warren, 1997: 164).

6. Changes Introduced – Extraordinary Revenues

(i) Scutage

Scutage arose originally as a feudal due owed to the king in respect of grants of land made to tenants-in-chief. As a condition of occupying land and receiving rents, etc., from it, tenants were obliged to provide a number of knights to fight on the king's behalf when called upon to do so, a formal summons to arms usually being a necessary formal precursor (though sometimes this was not done, as in 1202 and 1203 under John). The number of knights each tenant had to provide was fixed when the grant of land was originally made. The number of knights was the servitium debitum or 'service owed'. Each tenant, in theory at least, had to create a fixed number of knights. Each knight had an estate in land called a fee (he was thus 'enfeoffed'), to maintain him, which he held on condition of homage and service to his superior lord, in whom the ownership of the land remained vested. Hence scutage was often referred to as an aid on the knight's fee. Early in Henry II's reign, however, it became common for the service owed to be commuted to a sum of money payable to the king, at a rate calculated on the number of knights' fees a tenant had. So a tenant who had ten knights enfeoffed might be assessed at two marks per fee, and would owe the king twenty marks instead of sending his knights off to battle. Hence scutage also came to mean the money ('shield money') levied as well as the service which could be performed. The fact that there was a cash economy made such levies possible, and enabled them to be levied at different amounts. Not until a figure could be placed on the value of a knight's service would this have been possible.

There are some 'grey' areas surrounding scutage, however, which have not all been satisfactorily resolved. One concerns the number of knights actually enfeoffed. Henry II, again it seems in an attempt to raise revenue, carried out in 1166 an inquest of knights' fees. Tenants-in-chief had sometimes enfeoffed more knights than the number stipulated in the servitium debitum, sometimes fewer. Henry II's inquest (Mitchell, 1914: 3) sought to establish of each tenant-in-chief:

- for how many knights he owed service (the servitium debitum);
- how many knights had been enfeoffed before the death of Henry I (the 'old' enfeoffment); and

- how many knights had been enfeoffed after the death of Henry I (the 'new' enfeoffment).

If the number of knights enfeoffed (both old and new) exceeded the servitium debitum, Henry considered this number the servitium debitum, and tried to levy scutage on it. If the number enfeoffed fell short of the servitium debitum, then the latter remained. Henry thus attempted to collect scutage on all knights enfeoffed and to extend scutage, to make it a more general tax, not just one levied in times of war. For instance, he applied some of the money gathered from the 1168 scutage towards the expense of marrying his daughter Matilda to the Duke of Saxony though it was levied after the event. He did not succeed in extending the scope of scutage. The tenants-in-chief subscribed on their servitia debita, but not on the excess, though the Exchequer recorded amounts assessed on the excess as debts. In 1187, though, Henry had to concede and clear the debts, though it does seem that he managed to squeeze a slight increase from the barons over their servitia debita (Warren, 1987: 156, citing Keefe, 1983: 52).

The 1166 inquest established clearly that there were fees in existence in excess of the servitia debita. This actually put another tax weapon into the royal fiscal armoury. Those fees in excess of the servitia debita could become a potential target for raising additional revenue, and this is possibly reflected under John, when the notion of the fine came into its own. In this sense a fine is not a financial punishment for a violation of law or privilege (this was usually referred to as an amercement), but derives from the Latin word 'finis', which means at root 'end', and was used in the sense of settling an issue or bringing it to an end, most frequently in the sense of coming to a financial agreement over a particular matter. In addition to paying scutage, tenants often paid a sum of money in fine. Sometimes this was regarded as part of the scutage, sometimes it was dealt with separately. As to what the fine actually represented is, in any given case, unclear. It could be calculated as a single sum or a fixed amount per fee. Mitchell (1914: 5), the key source of comment on this, explains that the extra amount was to enable the king to hire a substitute for the tenants and their knights, as the amount of the actual scutage itself was not enough by itself to put men in the field in their place. He further comments (1914: 27) that the fine was reckoned in two ways: a lump sum by virtue of which the tenant was exempt from service and was given the right to collect scutage from his sub-tenants; and a fine for his personal service and for the right to collect scutage on the infeudated part of his holding. Even if he paid scutage so as not to send his knights, a tenant could still be liable for his own personal service. A tenant-in-chief could actually meet his obligations by sending another to serve in his place (Mitchell, 1914: 48). Mitchell (1914: 5) says that these 'sums were called fines ne transfretent or pro passagio'. The term 'ne transfretent' means literally 'in order that they should not cross the sea', so could possibly

mean that the fine was paid so that no one had to serve overseas (be it tenant or knights) – but could conceivably mean that they could still be called upon to serve in England. 'Pro passagio' literally means 'for the passage' or 'for the passing', which could refer to the same idea, but is more likely to refer to the tenant-in-chief being granted permission by the king to recoup his scutage and fine from his own sub-tenants. The tenant-in-chief was responsible for paying all monies due or agreed. The sub-tenants (sometimes called rear-vassals), although they would have had to perform any actual military service, were not liable to pay any monies unless they held land as an honor in their own right. Mitchell records several cases where sub-tenants were mistakenly charged, but on investigation found not to be liable. Collection directly from a sub-tenant could, however, be arranged through a sheriff (see Mitchell, 1914: 29).

A fine 'ne transfretent' is surely exactly the same as commutation of service in the first place (whether applied to a tenant-in-chief personally and/or his knights), but is just an extra amount for the same thing, so in this sense in indistinct from scutage proper. One is left wondering how the king, especially John, managed to succeed in raising fines without significant opposition, at least in the early years of his reign. Perhaps one argument is that the feudal spirit was deeply imbued in the tenants-in-chief. They knew that the king could insist on full military service, which would likely be more expensive than scutage proper plus fine. Also, given the established fact that there were more fees in existence than the servitia debita, this meant that a threat of re-assessment always hung over their heads. Henry II had tried to raise additional revenue on the excess fees, but though he had failed, he had not actually attempted a fundamental re-assessment. However, under John it does seem as if different aspects of 'not serving' were exploited, and scutage was becoming divided into two different taxes, much like the increment/profits from county farms considered above. Here John was making individuals accountable on an item by item basis for income and expenditure, and there was the distinct possibility, given his flair for administrative matters, that he might attempt to reform the servitia debita to reflect the true situation in his reign, when there were likely to be significantly more knights than before. (This is the implication throughout the survey by Faulkner (1996), though she looks at knights in thirteenth century England to establish this.)

In addition, fines were not necessarily levied at the same rate per individual, and there is a possibility that this element was negotiable. Again, there is inherent a suggestion of flexibility, which might take into account an individual payer's circumstances. Like the increment on the county farm, this represented an amount over and above a fixed rate, which allowed a level of variation not feasible in the fixed fee rate. John had also learned from his father's failure to extend the scope of scutage. The fine could have actually achieved what Henry had set out to so, but in a more subtle manner. John did not seek to levy scutage proper on an increased number of fees, but he

succeeded in raising extra money by way of fine. The permission granted ('pro passagio', perhaps) meant that tenants-in-chief could recoup moneys from knights/sub-tenants, not just from their servitia debita: they would be more likely to recoup from all the knights they had enfeoffed. If so, this measure achieved what Henry had set out to do, but John had not tampered with familiar feudal institutions to do it.

Flexibility in application seems to have brought its own rewards. Given how much income John managed to raise, it may seem surprising that Magna Carta did not come about earlier than it did.

Detailed investigation of all the eleven scutages levied by John in his sixteen year reign are provided by Mitchell (1914). Henry II levied scutage seven times over his thirty five year reign - in 1161 at two marks per fee; in 1162, 1165 and 1168 at one mark per fee; in 1172 and 1187 at twenty shillings; and in 1190 at ten shillings. Richard I levied the tax three times in his ten years as king – at twenty shillings per fee in 1089, 1195 and 1196. John raised the tax as follows.

Year	Reason
1199	Campaign against Philip Augustus
1201	War against the Lusignans
1202, 1203,1204	War against Philip Augustus
1205	Invasion of Poitou and Gascony
1206	Invasion of France
1209	War against Scotland
1210	Expedition to Ireland
1211	Two expeditions against the Welsh
1214	Invasion of Poitou

Mitchell (1914: 19) comments that John broke with custom in levying scutage at the beginning of campaigns, not at the close, and quite often 'the character of the operations which followed would hardly justify their levy'. In 1199, he concluded a truce immediately after landing in France, and in 1201 there seems to have been no fighting at all (Norgate, 1902: 81). The scutage of 1201 seems to have been paid partly on the king's departure and partly at a later date. Certain barons were relieved of some money but allowed to go home once they had reached Portsmouth (Mitchell. 1914: 35). In 1209, John marched north as far as Norham, apparently against the Scots, but concluded a truce without any fighting taking place. In 1202 and 1203 there seems to be no copy of a summons, though scutage was levied. In 1204 and 1205, the host was summoned, but not despatched. Mitchell (1914: 19) comments that the levy of 1204 'merits special notice' because it is said to have been granted by a meeting of the great council. This may mean that the barons agreed to an increase in rate and that the king should levy it before the

expedition – but it may carry overtones of a warning that the tenants-in-chief were becoming less than happy with John's continued exactions.

It is often thought that at this time John was seriously pressed for money, especially in comparison with Philip Augustus. However, Barratt (1996 and 2001) has analysed revenues under both Richard I and John, and posits that John's downfall in the loss of Normandy in 1204 was not the result of an imbalance of finance as compared with Philip Augustus. Indeed, John had significant revenue at his disposal and increasing amounts after that time as he mustered resources to fund attempts to recapture lost lands.

In 1205 scutage appears to have been levied after the host was dismissed. The barons opposed the expedition to Poitou and Gascony, and in 1214, the northern barons particularly opposed fighting in Poitou, on the grounds that service overseas was not due. Scutage was collected, but there was much opposition.

The rate of scutage under John was generally two marks per fee, but this rate could be varied. The 1204 scutage was at two and a half marks per fee; in 1206 and 1209 it was twenty shillings; in 1210 it was at two marks per fee, though most paid three, and fines that year 'exceeded anything imposed before' (Mitchell, 1914: 99); and in 1214 it was levied at a rate of three marks per fee.

Mitchell (1914: 23–24) also cites some instances of apparent double exaction in that scutage was paid by individuals whose knights did go on expedition with the king. The abbot of Ramsey paid eight marks on his four fees,[9] yet his knights were with the king, as did the bishop of Winchester,[10] while the earl of Devon had knights in the king's service and paid thirty marks scutage.[11] It seems generally true that tenants who performed their service received writs of quittance (i.e, acknowledgement that they should not pay money too), but if the tenant had fees which were in a different county, this might be delayed in coming through. A writ of quittance seems to have been required if a tenant was not to be held liable for scutage.

(ii) Carucage and Danegeld

The Pipe Rolls of Henry II show that he levied Danegeld twice during his reign, in 1155 and 1161, but there are no records of subsequent levies (Warren, 1987: 146). Danegeld was originally a specific tax levied to provide resources to fight off attacks from the Danes, though it was actually only called this in the twelfth century, following the description in the

[9] Pipe Roll, 1 and 7, John, Cambridgeshire and Huntingdonshire.
[10] Pipe Roll, 2 John, Hampshire, m. 7 d.
[11] Pipe Roll, 1 John, Devon, m. 14 d; 2 John, Devon.

Dialogus de Scaccario, written by Henry II's treasurer, Richard FitzNeal. It was levied under Henry I regularly, but fell into disuse under Henry II, seemingly because the basis on which it was levied (on 'geldable' lands, based on a unit of land known as a hidage) could not provide adequate sums to fund expensive continental wars. Henry I compensated for the inadequacy of the yield by levying it more frequently. However, it did have a unique trait in that it had a national character, 'being levied throughout the realm at a standard rate as a public duty' (Warren, 1987: 145). It was, however, never formally abolished, and Henry may have introduced a substitute for the old form, in what the *Dialogus* refers to as 'common assessments', but about which nothing much is known (Warren, 1987: 146–147). In 1198, to raise money for war with France, an effort was made under the judiciarship of Hubert Walter to establish a new basis of assessment on a unit of land known as a carucate, which was 100 acres of plough land, though it does seem as if a similar basis was used to raise part of the ransom for Richard in 1194 (Mitchell, 1914: 7). Carucate appears to mean the same as hidage, which was an older Anglo-Saxon word for the same thing.

There was an elaborate procedure for assessing liability:

> A commission was appointed for each shire consisting of two nominees by the crown and two by the shire court. Each hundred was to nominate two knights before whom a delegation of the reeve and four men from each vill testified. Landlords or their stewards could challenge or confirm the testimony of the villagers. When the knights of the hundred were satisfied they reported to the county commissioners, who, when they were satisfied had the details enrolled with copies for the sheriff, the hundred and estate stewards.....[E]state holders were responsible for the payments due from their lands in each vill; the money was to be tendered to the headman of the hundred and the two knights who had conducted the assessment; they paid it over to the sheriff who accounted for it at a special exchequer of receipt.
>
> Warren, 1987: 147

Despite all this care, there were suspicions of malpractice, and the Pipe Rolls reveal that twenty three counties offered lump sums for quittance or to be quit of an enquiry into the carucage (Warren, 1987: 147; Mitchell, 1914: 8, footnote 26).

John raised tax by use of this method only once in 1200. It was for a specific purpose – to raise the 20,000 marks John had promised Philip Augustus as a relief for his lands in France. The tax met with considerable opposition, especially from the Cistercian monks, who had a general immunity from taxation, and would not pay without the agreement of their order. John punished them by removing the protection of the Courts from them, though the two were reconciled (Mitchell, 1914: 34). There is no record of how the tax was collected or administered, or how much it raised. There is no record of it being used again until 1220 (under Henry III), when it met

with similarly stiff opposition, though it was levied 'by the simpler expedient of counting ploughteams' (Warren, 1987: 147). The attempt to bring Danegeld up to date seems to have been unsuccessful, and unpopular. It attempted to be meticulous and exact. Perhaps these concepts were ahead of their time, as the process was hampered by the administrative machinery required to implement it. However, in its attempt to use plough land as a basis of assessment, it would have affected the vast majority of the population, as England was primarily an agricultural society.

(iii) Tallage

Tallage was a customary, if arbitrary, tax levied on the towns and demesne land of the Crown. It was another way of increasing the yield from the royal demesne. It was applied to unfree tenants and was a parallel to the 'gracious aid' or auxilium which could be levied from vassals and free tenants. Lesser lords could also levy tallage and auxilium on their own subjects, but generally did so on a smaller scale than the Crown. While Danegeld was in operation, tallage tended not to be levied, as Danegeld had a wider assessment base, but with this failing to raise the sums needed and with its substitute, carucage, not being a great success, tallage became more widely used, the first notable instance being in 1168 under Henry II. Something of the nature of an 'aid' was evident in tallage too, as it was only taken

> when the king had urgent need of additional money, and although it could be imposed at the king's will, it could not be refused, the amount to be paid was not determined arbitrarily but was open to negotiation.
>
> Warren, 1987: 154

The method of imposition was as follows. Itinerant justices (as part of a normal visitation of the shires or specially commissioned) required each urban or manorial community to make the king an offer. If the offer was acceptable, the community itself was allowed to apportion and collect the tax. If it was not forthcoming or was not acceptable, the justices assessed contributions from individuals, which the sheriffs collected (distraining defaulters if required). Collective offers were frequently made, but in 1168 and sometimes afterwards, the justices seem to have made per capita assessments. Collective offers were usually paid promptly, which was efficient, as it meant that individuals did not have to be pursued for debt (Warren, 1987: 154–155). However, under John, the levies were much more frequent than previously, with per capita assessments being used in preference to collective offers.

Tallage was collected nine times in one form or another in John's reign (1199–1200, 1201, 1203, 1204, 1205, 1206, 1210, 1211 and 1214), the collections often reflecting scutage in the same years. Not all areas were

assessed in total. The 1199-1200 tallage appears to have been general (Mitchell, 1914: 31), but in 1201 it was collected in the bishopric of Lincoln and Yorkshire, while some sort of aid was collected in the Channel Islands (Mitchell, 1914: 45). In 1203 it was collected in thirteen counties with an account of collections in fourteen counties in 1204, twenty six counties in 1205 and thirty two counties in 1206 (Mitchell, 1914: 61, 68, 76, 82). It was collected in 1210 from cities, towns, the king's manors and lands in hand (Mitchell, 1914: 100), with the Jews being tallaged for 66,000 marks in that year also. One of the chroniclers (see Norgate, 1902: 137) reports that at the beginning of 1210 all the Jews in England, of both sexes, were arrested by order of the king, and tortured to make them give up their wealth.

> It was reported that the king wrung ten thousand marks from one Jew at Bristol by causing seven of his teeth to be torn out, one every day for a week.
> Norgate, 1902: 137

A final tallage is recorded in John's reign in 1214, charged against manors and towns, with the aim of raising money to help pay the indemnity for the withdrawal of the papal Interdict, which was set originally at 100,000 marks (Mitchell, 1914: 117).

(iv) Dona or Auxilia

An auxilium was an aid, given in theory, at least, voluntarily to assist royal finances. There were three occasions on which it was normal for a 'gracious' (meaning reasonable) aid to be raised - for the king's ransom, for knighting the king's son and for marrying the king's eldest daughter (Ormrod, 1999: 27). Dona, on the other hand, were gifts, often raised from religious houses or churchmen but the terminology seems rather blurred. Aid was often used to refer to a tax in general (e.g., an aid on the knight's fee in respect of scutage) and a gift might be anything but a gift. Calling it so, however, was perhaps useful in disguising the nature of the exaction. Some religious houses paid a contribution in 1199 which was variously referred to as a donum, promissum or tallagium (Mitchell, 1914: 32), though in 1203 contributions from religious houses in Dorset were referred to as auxilia (Mitchell, 1914: 61). Sometimes the payment gave exemption from military service, sometimes it was not at all connected with it, as seems to be the case of the charge against twenty six religious houses which occurred in 1204 (Mitchell, 1914: 68). It would depend on whether the tenure of the religious house had been granted with the obligation of providing military service: sometimes this is unclear, as in the record of charges from religious houses for 1205 and 1206 (Mitchell, 1914: 70, 77, footnote 325). Mitchell (1914: 105) refers to 'enormous sums' being levied on the religious houses after the Irish campaign (various amounts are mentioned of

£18,000, £22,200 or £40,000 being charged against the Cistercians, the latter part of a charge of £100,000 against religious houses). The source for this is the chroniclers, as no such amounts appear in the Pipe Rolls.

(v) The Tax on Moveables

Taxes on moveable property to raise state revenue were not used until the twelfth century, and then not extensively. They were common in terms of the ecclesiastical tithe, so the concept was familiar. Indeed two of the Church's taxes, in support of campaigns to relieve the Holy Land, developed the concept on a national scale. In 1166, a tax of six pence in every pound's worth (approximately one fortieth) of annual income and of chattels was taken from all laymen and clergy for the relief of the Holy Land (Warren, 1987: 148). A more rigorous procedure was used in 1188, when, in response to an appeal from the Pope to rescue Jerusalem from Saladin, one tenth of their annual income and moveable property (except arms, horses, dress and precious stones) was demanded by the king from all laymen and clergy who had not taken the Cross (Warren: 1987: 148). This became known as the Saladin Tithe. Crusaders were exempt, and also received the tithe of their men. The assessment was made by parishes.

> In each, two churchmen of the parish, a Templar, a Hospitaller, a sergeant and a clerk of the king, a sergeant and clerk of the baron of the parish, and a clerk of the bishop of the diocese formed the body of assessors. Each man swore to the value of his revenues and personal property before this commission..... Those who tried to evade the tax were excommunicated.
>
> Mitchell, 1914: 6

The same kind of tax was levied in 1193–1194 in an attempt to raise the ransom of 100,000 marks demanded for Richard's ransom. This was levied, however, at the rate of a quarter of revenues and on moveables too, according to one chronicler. It is not known how much was raised by this levy, and information as to how exactly it was collected is sparse, but it is likely that 'lump sum payments were accepted in lieu of careful assessment' (Warren, 1987: 148) in attempts to raise money speedily.

Although the Holy Land levies and the ransom for Richard were exceptional in every way, and appealed to a deep moral obligation, nevertheless they were both novel and national, and John learned from these precedents. He used such levies four times in his reign – in 1201, 1203, 1204 and in 1207. In 1201 a levy of one fortieth of the revenues of one year was raised in accordance with the Pope's request for aid for the Holy Land. Churchmen paid by order of the Pope on their spiritualities and temporalities, and it was collected by the bishop of each diocese. The king also contributed one fortieth of the revenues of his demesne, escheats, wardships,

and lands in hand, and he asked earls, barons, knights and freemen to contribute at the same rate. There was no formal assessment, and each man himself calculated the amount of his contribution. A roll was drawn up by the collectors, arranged by vills, containing the names of the contributors and the amount paid by each. The royal demesne was dealt with on a separate roll. Those who refused to pay were reported by name to the king (Mitchell, 1914: 45). Although it is unlikely that the tax raised was substantial, nevertheless the detailed accounting and the machinery of collection were novel, and it should perhaps be borne in mind that this was a forerunner for the other levies of this sort in John's reign, such as the fifteenth collected in 1204 on the property of merchants, which was collected by a similar means. This latter tax was novel, in that it was a kind of customs duty levied at the ports. Three men were appointed by the king, and responsible to them, six or more men of each port, one knight and one clerk (called baillivi of the fifteenth) were chosen to collect and administer the tax in their own town by drawing up a roll containing the names of the merchants and a list of their payments (Mitchell, 1914: 69). Warren (1997: 122) comments that, although this tax is dated at 1204, it was in operation at least two years before.[12] In Barratt's view (1996: 841) this is not significant and he disregards it in his revenue calculations in the absence of substantial evidence. Ormrod (1999: 32) considers that this was the progenitor of later customs duties which came to be considered to be part of the ordinary revenue of the crown. The tax lasted for about five years until a truce with Philip Augustus again allowed free trade. It was part of the measures put in place to control trade with the continent, especially France, and was part of John's wider measures to ensure maritime power was in his hands. The concept of a royal navy is usually attributed to John, and it seems that taxes raised from tin mines in Cornwall and Devon may have been put specifically to the purpose of developing and maintaining the royal fleet (Warren: 1997: 124–125). Perhaps following on from this, in 1206, a tax was imposed on the sale of wines, for infringement of which penalties were heavy.

In 1203 a levy of one seventh of personal property (apparently) was made. There is some confusion as to the rationale behind this, as the chroniclers report that it was taken on the pretext that the barons had deserted John on his return to England in December of 1203. However, as the tax was levied in the summer, this does not hold water. It seems to have been some sort of general levy, possibly of tenants-in-chief and clergy. In 1203 also a levy of a fifth of one year's revenues was taken in the Channel Islands on the lands of bishops, abbots, clerks, knights, rear-vassals and others to support the knights and sergeants defending the islands (Mitchell, 1914: 63–63).

[12] Rot. Pat., i. 42.

This shows the attention being paid more and more to personal property as a means of raising tax.

The largest levy of this kind, however, was the thirteenth (more exactly twelve pence in the mark) of revenues and moveables taken in 1207. The levy seems to have been requested in the form of a 'gracious aid', which was unusual, but not without feudal precedent among the tenants themselves (see above). However, John had no immediate need of this, and it seems to have been collected against a perceived future need to recover lands lost to Philip Augustus in France (which could have been genuine or a mere pretext). John persuaded a council of his barons to agree to this charge on them, though not without protest: prelates in a first council had refused this as a levy on beneficed clergy, though both laity and clergy did later pay it (though not some prelates apparently). Many clergy paid a lump sum in fine. It was collected by a means similar to the levy of 1188 (see above), though by teams of special justices sent to each county, as many as fourteen being reported for Lincolnshire. It seems to have raised about £60,000 (Warren, 1987: 148–149; Mitchell, 1914: 84–92). The penalty for refusing to comply with procedures was forfeiture of chattels and indefinite imprisonment. The archbishop of York was forced into exile for opposing the tax and his lands were seized (Mitchell, 1951: 8).

The tax of 1207 was an important step away from feudal taxation towards national taxation. It was levied against an unspecified future need, on property not land, and most classes of society paid it (except, perhaps, for some of the clergy). It was collected on a national basis, using the vill (a national unit), not the feudal holding, by royal justices – and using a form of self-assessment. It was legitimized because agreed with a body which represented the community in general who would suffer it. John was not able to take such a tax again, owing to differences with the barons in later years when he might have tried to raise such sums. It is a testament to the king's skill that he managed to get this through at all.

(vii) Church Revenues

In consequence of John refusing to accept Stephen Langton as Pope Innocent III's appointee to the see of Canterbury, England was put under a papal Interdict. As a result of this, most sources concur that John just grew richer. Almost immediately the Interdict was declared, royal officers moved in to seize Church property – and John let it be known that the clergy could regain it if they paid for the privilege, though even then the king retained some portion of the Church revenues (Warren, 1997: 167–168). John's finances were immensely increased in the years of the Interdict (1208–1214), though he was not dissuaded from levying other taxes. It is

not really possible to estimate exactly how much the Church revenues brought in, but the sheriff of Northampton accounted at Michaelmas for £1,000 gross receipts from Peterborough in six months, and the next year the prior recovered control of the abbey estates for £600 per annum (Warren, 1997: 168). If Church lands fell vacant because of the death of an abbot, say, John took them in hand. Seventeen monasteries had suffered in this way by 1213 (Warren, 1997: 173). It cost John 100,000 marks to end the Interdict in 1214 – 40,000 before it was lifted and 12,000 per year thereafter. Of the 40,000, 13,000 were pardoned (Warren, 1997: 210). Even then John took a tallage to raise the revenue to pay this (see above).

Another scheme was also thought up for relieving the clergy of substantial sums of money. Although priests were supposed to be celibate, the Church had great difficulty in enforcing this, and many parish priests, it is believed, had undergone some form of marriage, or kept housekeepers, who were rather more than this. Henry I had fined the clergy for disobeying the Church in this matter – at the same time as selling them licences to do so. John ordered all the clergy's womenfolk of this nature to be seized and held for ransom. Many hurried to obtain the release of their womenfolk (Warren: 1997: 168).

7. Conclusion

The above review of (largely) secondary evidence shows three predominant features:

(i) Attempts occurred to increase royal revenues, both ordinary and extraordinary, by almost any means possible.
(ii) As part of the above, a change came about in the nature of taxation from feudal dues to taxes that had a national character, in that they were levied across all classes of society.
(iii) This change in nature was accompanied by a growing recognition that taxation could not be imposed merely by the will of the king: it needed the consent of those taxed and regulation.

The Magna Carta[13] has explicit references to the need for consent and regulation in financial matters. Clause 2 refers specifically to the amount of relief due on inheritance by tenant's heirs; Clauses 3 and 4 to guardianships of minors; Clause 6 to the marriage of heirs; Clauses 7 and 8 to the widow's right to her marriage portion and inheritance and her rights in re-marriage. Clause 9 restricts the right to seize a debtor's goods, if his chattels cover his

[13] The version of the Magna Carta referred to here is that in Appendix B of Warren, 1997: 265–277.

debts. Clauses 10 and 11 deal with borrowing from Jewish money lenders, restricting interest chargeable on heirs and by the king if the debt falls into his hands. Clause 12 says that no scutage shall be taken unless by common counsel, unless for ransom, making the king's eldest son a knight or marrying the king's eldest daughter, while Clause 13 requires 'common counsel' too in assessing an aid. Clauses 17–19 deal with stabilising justice procedures within the counties where they occur for issues of novel disseisin (forcible dispossession), mort d'ancestor (death of an ancestor) and darrein presentment (concerning vacancies). Clauses 20–22 deal with relief from amercements for trivial offences and Clauses 26–32 with seizure of property from various classes of persons, and when this will be legal or not. Clause 41 frees merchants from 'evil tolls' except in time of war. Clause 43 deals with escheats, and 44, 47, 48 and 53 with forestry issues, promising enquiry into 'all evil customs'. Clause 49 deals with the return of hostages; Clause 51 deals with illegal dispossession; and Clause 55 deals with unjust fines.

The clauses sometimes mention specific individuals or particular classes affected by a measure, but in large the application is to all persons. While this paper does not seek to examine in detail the Magna Carta clauses per se, even a brief look gives a fair impression of how his subjects had come to regard John's financial exactions. Although there are many reasons alleged for the Magna Carta coming into being, the text itself reflects primarily resentments at the treatment of property and persons by the king in a financial context.

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10

Estate Planning in Early-Modern England: 'Having' in the Statute of Wills 1540

NG JONES*

ABSTRACT

FROM ITS ENACTMENT in 1540, until the abolition of the royal feudal revenue in the following century, the Statute of Wills determined the scope of the income available to the Crown from the incidents of tenure. In a seminal article in the 1966 *Law Quarterly Review*, J.L. Barton pointed to a 'gap' in the statute, in that it applied only to persons 'having' an estate of inheritance in the land affected. This paper takes up Barton's observation, and seeks to test it in the context of purchases of land in trust in the names of others, both in terms of conveyancing practice, and in terms of the response to such trusts of the Court of Chancery and the Court of Wards. In contrast with the contemporary practice of taking long leases rather than fees simple, the evidence concerning the revenue consequences of purchases in trust in the names of others is not yet plentiful. But it is sufficient to lend support to Barton's thesis, and to suggest that such trusts were a cause for concern to those charged with administering the Crown's feudal revenue.

Much of the story of feudal land-holding in England between the conquest and the statute *Quia Emptores Terrarum* (1290) is of a shifting balance of importance between the services owed to his lord by a feudal tenant, and the incidents of tenure. Land was to begin with granted to feudal tenants in return for their services, and if a tenant in knight's service died leaving an infant heir, unable to fill his father's place in the feudal host, the logic of the arrangement dictated that the land, the *quid pro quo* for the services, should during the infancy fall back into the hands of the father's lord. And if the heir's inability to perform the service stemmed not from his

* Unless otherwise indicated all manuscripts are in the Public Record Office. Extracts from manuscripts in law French have been translated. Extracts from manuscripts in English have been rendered into modern orthography and punctuation. The year is taken to begin on 1 January.

infancy but from her sex, there was logic too in requiring the lord's consent to her marriage.[1]

But payment of shield money rapidly replaced the obligation of personal service, the fixed sum ceasing to represent the value of the land. Services, once the rationale of the arrangement, lost priority to the incidents of tenure. Wardship and marriage, arising in situations which had endangered the services, now gave the lord, albeit temporarily, the full value of his tenant's land. Any lord might benefit, but the greatest beneficiary was the king, always lord, never tenant, and possessed not only of the rights of ordinary lords but of certain prerogative entitlements too.[2] The Speaker of the Commons had argued in 1404 that 'the king had Wardships of all the lands of the nobility, and these Wardships and Customs were granted originally to cover the cost of wars, so that the country might not be subject to taxation',[3] but long before the time of Henry IV 'these feudal dues', as Joel Hurstfield put it, 'were already, in effect, a tax: a land tax which was distorted, anachronistic, irregular and inefficient, but a land tax *faute de mieux*'.[4]

The anachronism achieved its final flowering in the Court of Wards and Liveries, established in 1540 to supervise the collection of the Crown's feudal revenue.[5] The court lasted for a little over a century,[6] and that, as J.H. Baker has put it, 'was the end of fiscal feudalism. Public revenue has thereafter been raised by other methods, designed to spread the burden more widely'.[7] But of these other methods there are many more competent to speak than I, so I will hurry back before the Restoration to the revenue administered by William and Robert Cecil and their successors as Masters of the Wards.[8]

It was impossible at common law to make a will of freehold land: all land of which a tenant was seised at the time of his death would descend to his heir.[9] But the law did not represent reality: by conveying land *inter vivos* to trustees, known as feoffees to uses, and directing their disposition of the

[1] For the history of land-holding in post-Conquest medieval England see J.H. Baker, *An Introduction to English Legal History*, 4th edn (2002), chs 13–15, and S.F.C. Milsom, *Historical Foundations of the Common Law*, 2nd edn (1981), chs 5–9. More detailed treatment will be found, *inter alia*, in A.W.B. Simpson, *A History of the Land Law*, 2nd edn (1986), and S.F.C. Milsom, *The Legal Framework of English Feudalism* (1976).

[2] That is, primer seisin and prerogative wardship.

[3] J.H. Wylie, *History of England under Henry IV* (1884), i, 407.

[4] J. Hurstfield, *The Queen's Wards* (1958), p. 5.

[5] For the Court of Wards and Liveries see H.E. Bell, *An Introduction to the History and Records of the Court of Wards and Liveries* (1953).

[6] Following a period in which there were two rival courts, a Parliamentary one at Westminster, and a Royalist one in Oxford, Parliament gained the upper hand in 1646. The court was abolished and not revived.

[7] Baker, *Introduction*, p. 257.

[8] William Cecil, Lord Burghley, Master of the Wards 1561–1598, Robert Cecil, Earl of Salisbury, Master of the Wards 1599–1612.

[9] There were certain customary exceptions to this rule. Should there be no heir, the land would pass to the lord by escheat.

land by will, the tenant could in effect make a devise.[10] But if the plot was the possibility of making, in effect, a will of freehold land, the 'sub-plot' as S.F.C. Milsom has put it,[11] was the evasion of the revenue: land which was devised would not descend to an infant heir and would be beyond the scope of wardship. The Crown had the most to lose, and with the Statute of Uses 1536,[12] which executed uses of freehold land, removing the legal title from the feoffees to uses and vesting it in the beneficiary, it seemed that the possibility of making a will of freehold land, and the consequent loss of revenue, had been cut off altogether.[13]

But the triumph was too complete to last, and in the Statute of Wills 1540,[14] followed two years later by an explanatory statute,[15] came a retreat. A tenant by knight's service might now devise two thirds of his land, provided that the remaining third was left to descend to the heir.[16] Provision was also made for land granted away *inter vivos*. The statute gave power to dispose of two-thirds of the land not only by will, but also 'by any act or acts lawfully executed' in the tenant's lifetime, 'for the advancement of his wife, preferment of his children, and payment of his debts or otherwise'.[17] This was not the true conferment of a power: there had been power at common law to grant land away *inter vivos*.[18] The provision was aimed rather at preventing the circumvention of the two-thirds limit by means of alienations *inter vivos* instead of by will, and before the end of the sixteenth century it was settled that the acts executed during the tenant's life which fell within the statute were limited to those most like the purposes for which land was commonly devised: that is, for the benefit of wife or children, or for the payment of debts.[19]

[10] For recent work on the medieval use see J. Biancalana, 'Medieval Uses' in R. Helmholz and R. Zimmermann, eds, *Itinera Fiduciae: Trust and Treuhand in Historical Perspective* (1998), p. 111.
[11] Milsom, *Historical Foundations*, p. 208.
[12] 27 Hen. VIII, c. 10.
[13] For the origins of the Statute of Uses see E.W. Ives, 'The Genesis of the Statute of Uses' (1967) 82 *English Historical Review* 673. The statute provided in s. 1 that the beneficiaries of uses 'shall from henceforth stand and be seised, deemed and adjudged in lawful seisin, estate and possession of and in the same honours, castles, manors, lands, tenements, rents, services, reversions, remainders and hereditaments, with their appurtenances, to all intents, constructions, and purposes in the law, of and in such like estates as they had or shall have in use, trust or confidence of or in the same'.
[14] 32 Hen. VIII, c. 1. For the origins of the Statute of Wills see J.H. Baker, ed., *The Reports of Sir John Spelman*, vol. 2 (1978) (Selden Society vol. 94), pp. *195–203*, and J.M.W. Bean, *The Decline of English Feudalism, 1215–1540* (1968), pp. 293–301.
[15] 34 & 35 Hen. VIII, c. 5.
[16] Ss. 4, 7–11.
[17] For a more detailed exposition of the provisions of the statute see M.C. Mirow, 'Readings on Wills in the Inns of Court 1552–1631' (unpublished University of Cambridge Ph.D. thesis, 1993).
[18] As Henry Sherfield put it in 1624: 'It is said he shall have power to give etc. 2 parts but by an act executed every person in all cases may convey the whole, therefore the whole scope of the law is to give power to devise', British Library (BL) MS. Stowe, fo. 42.
[19] J.L. Barton, 'The Statute of Uses and the Trust of Freeholds' (1966) 82 *Law Quarterly Review* 215 at 222–223.

In applying these criteria, the Statute of Wills, as J.L. Barton said in 1966, had

> [t]he great merit from the point of view of the Crown … that it adopted as its decisive criterion not the form of the settlement which the King's tenant might employ, but the persons who were to benefit under the disposition. The trust, therefore, was no more effective as a means of avoiding feudal casualties than a simple will would have been.[20]

An alienation *inter vivos* to trustees upon trust for a child, for example, was within the statute just as much as a conveyance to the child directly.[21] But there was, as Barton put it:

> one gap in the Statute of Wills. The statute applied where any person 'having' an estate of inheritance disposed of it for the advancement of his wife, preferment of his children, or payment of his debts. Thus if A, seised in fee of Blackacre settled it upon the wife and children of B, this was not within the Act. The case was no different if B had bought Blackacre, but had prudently had it conveyed to his wife and children rather than to himself.[22]

This last point, Barton argued, followed *a fortiori* from the case of one who took an estate jointly to himself and his son. Certain conveyances to joint tenants had been anticipated, section 9 of the Statute of Wills 1540 providing that where two or more persons held land 'of the king … by tenure of knight's service, jointly to them and to the heirs of one of them', if the joint tenant who had the inheritance died leaving an infant heir, the king was to have wardship, irrespective of the surviving joint tenant.[23] But not all joint tenancy arrangements were caught by this provision.

[20] Barton, 82 *LQR*, 223.
[21] For further discussion of this and related points see N.G. Jones, 'The Influence of Revenue Considerations upon the Remedial Practice of the Court of Chancery in Trust Cases 1536–1660' in C. Brooks and M. Lobban, eds, *Communities and Courts in Britain, 1150–1900* (1997), p. 99.
[22] Barton, 82 *LQR*, 223. Section 4 of the Statute of Wills 1540 provided that 'all and singular person or persons having any manors, lands, tenements, or hereditaments of estate of inheritance holden of the king's highness in chief by knight's service, or of the nature of knight's service in chief . . . shall have full power and authority by his last will by writing or otherwise by any act or acts lawfully executed in his life to give, dispose, will or assign two parts of the same manors, lands, tenements or hereditaments in three parts to be divided, or else as much of the said manors, lands, tenements or hereditaments as shall extend or amount to the yearly value of two parts of the same in three parts to be divided . . . to and for the advancement of his wife, preferment of his children, and payment of his debts, or otherwise, at his will and pleasure; any law, statute, custom or other thing to the contrary thereof notwithstanding'. Sections 7–9 made similar provision in the case of persons holding some land by knight's service in chief, and some of a mesne lord.
[23] For discussion of this provision see N.G. Jones, 'Trusts: Practice and Doctrine, 1536–1660' (unpublished University of Cambridge Ph.D. thesis 1994), pp. 240–241.

In 1624, reading on wills in Lincoln's Inn, Henry Sherfield found himself obliged to consider the application of the Statutes of Wills to joint tenants.[24] He was confident that the statutes' reference to persons being 'sole seised' did not mean that a conveyance by joint tenants could not be an act executed within the statute, for if this were the case a transfer to a plurality of trustees, followed by a direction to convey for the advancement of the transferor's wife, the preferment of his children, or the payment of his debts, would be a 'way open that the king will never have wardship nor livery'.[25] A marginal annotator of a note of the reading agreed: 'if I, being sole seised, convey to two or three in trust and then procure them to convey to my son, this is advancement without question'. 'But', he went on, 'if I purchase it in the names of others by original purchase as [in] *Myght's Case* then it will be otherwise'.[26]

Myght's Case (1610)[27] concerned a purchaser who took a joint estate in fee simple to himself and an infant, presumably his son. The arrangement was held in the Court of Wards not to fall within the Statutes of Wills, 'for the words are "having a sole estate or interest in fee simple etc"'. Neither was the arrangement by 'collusion' to take away the wardship within the meaning of section 15 of the Statute of Explanation of Wills 1542, 'because the [purchaser] was never sole tenant to the King'.[28] And so, as Barton said, *a fortiori*, a purchase by B of Blackacre, which he prudently had conveyed directly to his wife and children, would also be outside the statutes.[29]

'In principle', Barton continued, 'the case should be no different if B had bought Blackacre, but had it conveyed to a trustee, X, who subsequently conveyed to B's children. I do not know', he continued, 'of any direct authority for this last proposition but it would certainly explain why it was that in the sixteenth century the typical method of creating a trust of freehold seems to have been purchase in the name of another'.[30]

Direct authority is indeed not easy to find, but it was reported in the Court of Wards in the time of James I that 'if tenant *in capite* do assure over his estate in trust, or confidence to deceive a wardship that is a fraudulent

[24] BL MS. Stowe 424, fo. 39.
[25] BL MS. Stowe 424, fo. 46.
[26] BL MS. Stowe 424, fo. 46.
[27] 8 Co. Rep. 163b. See also Ley 16. It seems likely, as Barton thought, that the infant was the purchaser's son, though Coke's report gives them different surnames.
[28] Section 15 applied, *inter alia*, to the making 'by fraud or covin, contrary to the true intent of this act, any estates, conditions, mesnalties, tenures or conveyances to the intent to defraud or deceive the king of his prerogative, primer seisin, livery, relief, wardship, marriages or rights ... ', and provided that where such 'covin, fraud or deceit' was found by office, then the king should have his entitlements 'as though no such estates or conveyances by covin had ever been had or made, until the said office be lawfully undone by traverse or otherwise'.
[29] Being outside the statutes, the land could not be devised: there was no power at common law to make a will of freehold land. But it could be alienated *inter vivos* without the alienation counting as an act executed, and if not so alienated would be the son's by purchase and not by descent, and so outside the scope of wardship.
[30] Barton, 82 *LQR*, 223–224.

conveyance', and that 'if it were purchased to A and B jointly to the use of A for money paid by A if B die there is a wardship',[31] but 'if it be purchased in another's name at the first no cause of wardship'.[32] No express mention is made in this last scenario of fraud or collusion, but, as Barton observed, 'the judges, who were by no means the submissive guardians of the royal financial interests they are sometimes represented to have been', interpreted the collusion provisions in the statutes of wills so restrictively as to come close to interpreting them out of existence.[33] And if 'a purchase in the names of others by original purchase' such as that in *Myght's Case*, where the purchaser was included among those taking the estate, was no collusion, it is difficult to see that a purchase in the names of others not including the purchaser would be found collusive.

The danger to the revenue arising from purchases in the names of others is indicated by their inclusion in 1617, by the author of *Collections for the King's Majesty's service in point of his highness Prerogative*, among a number of 'wounds', as he put it, to the prerogative.

> The father purchases lands of the king's tenant *in capite* in the name of a stranger, and without any use limited, but only trusts the stranger being his near friend or kinsman or servant here the inheritance by law is in the stranger, the stranger he makes a grant or devise of this land to other strangers for 1000 years or more, and they to whom this lease is made, assigns [*sic*] over to the purchaser or his eldest son, who after the death of his father … enters and inherits. In this case … the king loses all.[34]

And circumvention of the revenue would explain, as Barton suggested, a complex settlement upon trust in William West's *Symbolaeographia*, a conveyancing precedent book published in 1590. Here the settlor bargains and sells land to five trustees, for the life of the settlor and a further ten years, with the remainder thereafter to the trustees and their heirs. There follows provision that a further five trustees, during the settlor's life or within seven years after his death, shall sell the land, or so much of it as the settlor shall direct, and within six months after the sale shall purchase other land of equal value, conveying the newly purchased land to the heirs of the settlor in fee simple.[35]

As Barton observed, '[a]t first sight, this settlement seems simply insane. It would be hard to devise a clumsier method of benefitting the settlor's heirs', but, he continued,

[31] This appears to be an application of s. 9 of the Statute of Wills 1540.
[32] Cambridge University Library (CUL) MS. Ii.5.17, fo. 44; CUL MS. Dd.3.9, fo. 121; CUL MS. Dd.13.28, fo. 14v.
[33] Barton, 82 *LQR*, 225.
[34] BL MS. Harg. 358, fo. 27v.
[35] W. West, *Symbolaeographia, which may be termed the Art, Description, or Image of instruments, covenants, contracts etc. or the Notarie or Scrivener* (1590), bk 2, s. 185.

> [i]t is submitted that this settlement is in effect a very ingenious piece of sixteenth-century estate planning … The lands which are sold are out of the case. The lands which are purchased are not lands which the settlor has ever 'had'; indeed, the intention seems to be that they should be purchased after he is dead. The King will therefore have no claim, and if the settlement should comprise all the settlor's lands, there will be no question of his heir's being in ward.[36]

The mechanisms in *Collections for the King's Majesty's service* and in West's *Symbolaeographia* are elaborate: both involve two groups of third parties. Perhaps, as Barton suggested, '[a]n expedient of this kind was too cumbersome to be generally popular'.[37] But if these mechanisms, as their sources suggest, represent the height of the conveyancer's art, simpler versions were not impossible. In *Diggs v Diggs and Boys* it was found in Chancery in 1598 that 'Thomas Diggs paid all the money for the … purchase [of the land] and yet took the conveyance thereof in the name of … James being his brother, and also that … James did afterwards make the said lease for 99 years now in question to … Thomas'.[38] Similarly, reading in the Middle Temple in 1615 on the statute 27 Eliz. I, c. 4, George Shurley considered a case in which 'A with my money, and by my direction buys land in trust for me in his name, and then by my appointment … makes a lease to me for 100 years'.[39] These mechanisms are not unlike that described by the author of the *Collections for the Kings Majesty's service*, but with the simplification that the lease is granted directly to the purchaser, rather than indirectly through a second third party.

Barton over-stated his case in suggesting that in the sixteenth century '[t]he landowner who puts his own property in trust is a very rare bird indeed',[40] but, as has begun to be apparent, there is evidence to suggest that purchases of land in trust in the names of others were not infrequent. Barton himself adduced four examples, three from Elizabethan pleadings in the Court of Chancery, and one, early Jacobean, from Cary's reports.[41]

[36] Barton, 82 *LQR*, 224.
[37] Barton, 82 *LQR*, 224.
[38] C 33/93 f 749.
[39] CUL MS Ee.6.3, fo. 79v.
[40] Barton, 82 *LQR*, 224. Work on the record of the Court of Chancery since Barton wrote has revealed significant numbers of sixteenth-century settlors putting their own land in trust. See N.G. Jones, 'Trusts: Practice and Doctrine, 1536–1660' (unpublished University of Cambridge Pd.D. thesis, 1994).
[41] *Seymour v Blagrave* (1572) C2 Eliz H24/25 (purchase by Edward Seymour, Earl of Hertford, in the name of Blagrave, upon trust to convey to the Earl within convenient time); *Hawthorne v Woods* (1579) C2 Eliz H14/8 (purchase of concealed lands from the Queen by Hawthorne, in the names of Woods and another upon trust to convey upon request); *Hill v Worth* (1591) C2 Eliz H15/37 (purchase of land by Worth with Hill's money, upon trust for Hill); *Merick's Case* (1603) Cary 30 (purchase of land by Young in the name of Mason, to the use of Young and his heirs).

The records of the Chancery and of the Court of Wards in the period reveal a number of others.[42]

And purchases of land in the names of others were sufficiently common to give rise to doctrinal discussion. So it was said in Chancery in the early seventeenth century that

> if I purchase lands in fee simple in the name of J.S, and this upon trust and confidence, and I die and this trust descends to my heir, he may exhibit his bill in Chancery to have his land estated in him and his heirs as I might have done.[43]

Similarly, it was said in Chancery before 1594 that 'If I give money to one to purchase lands therewith to him and his heirs, and to permit me to take the profits thereof during my life, and he withholdeth the profits, he shall be compelled by subpoena'.[44] Not all such purchases in the names of others were made with the intention of exploiting Barton's 'gap' in the Statute of Wills: the names might, for example, be those of factors or estate agents intended to make a more or less immediate conveyance,[45] or the mechanism

[42] For example, in *Dockwray v Lacy* the Chancery was told in 1601 that the defendant, John Lacy, had caused 'Rowland Lacy and Anthony Elcocke (in whose names . . . John Lacy purchased the … manor whereof the premises are parcel)' to refuse to accept a tenant of the manor: C 78/110/10. Similarly, in 1610 it was said in the Court of Wards that William Tey, seised of a manor, agreed with Charles Cornewallis and Christopher Sibthorpe for £1190 to convey the land 'unto them or to such as they should name and their heirs', whereupon a conveyance was made to Humfrey Burton and William Sibthorpe in trust for Cornewallis and Christopher Sibthorpe: WARD 9/90 f 556. For other examples see N.G. Jones, 'The Influence of Revenue Considerations upon the Remedial Practice of the Court of Chancery in Trust Cases 1536–1660' in C. Brooks and M. Lobban, eds, *Communities and Courts in Britain, 1150–1900* (1997), p. 99 at 106.

Trusts enabling the purchase of land in the name of another were not infrequently passive trusts of freehold in the form of a use upon a use. It has long been thought that because it circumvented the Statute of Uses a passive trust of freehold land was in itself, without more, a danger to the revenue. But that is to ignore the Statute of Wills. A purchase of freehold land in the names of others under a passive trust in the form of a use upon a use was a danger to the revenue not because the trust remained un-executed under the Statute of Uses, but because, as Barton said, there was 'one gap in the Statute of Wills'. And though purchases in the name of another were not infrequently passive and in the form of a use upon a use, that was merely a matter of convenience in structuring the conveyance: an active trust would have worked just as well. As I have suggested elsewhere, the story of the use upon a use is not of the survival of the trust, nor even of the evasion of the revenue: N.G. Jones, 'The Use upon a Use in Equity Revisited', a paper presented to the 15th British Legal History Conference, Aberystwyth, 2001.

[43] Herts. R.O. MS Verulam XII.A.50, printed in W.H. Bryson, ed., *Cases concerning Equity and the Courts of Equity 1550–1660*, vol. 1 (Selden Society vol. 117) (2001), p. 329. The note is undated, but the collection is from *c.* 1599–*c.* 1604.

[44] Cary 10. See also R. Crompton, *L'Authoritie et Iurisdiction des Courts de la Maiestie de la Royne* (1594), fo. 48b; CUL MS. Gg.2.31, fo. 178v; CUL MS. Mm 6.64, fo. 62; BL MS. Harg. 281, fo. 29v; BL MS. Harl. 736, fo. 189v; BL MS. Harg. 227, fo. 59v; BL MS. Stowe 296, fo. 45v.

[45] So in *Sharpe v Hill* (1568) the Chancery was told that land had been assured to the defendant 'upon special trust and confidence reposed by the plaintiff in the … defendant that … the defendant should make assurance thereof over unto the … plaintiff and his heirs': C 33/37 f 198. Similarly, in *Masterson v Masterson* (1597), it was found proved in Chancery that the plaintiff, 'being [the defendant's] factor and having a stock of his in his hand purchased the premises with the defendant's money and to his use and by his appointment': C 33/91 f 843.

might be intended to prevent the merger of lesser interests with the fee simple.[46] And it is not uncommon for the purchase to have been made in trust in the names of others to the expressed intent that the trustees make conveyance to the purchaser upon demand,[47] the trustees in some cases entering into a bond to do so.[48] On the face of things at least, such purchases do not look like attempts to circumvent the revenue. But there are a few indications of the possibilities.

In *Skynner v Skynner* (1600), it was found in Chancery that 'the manors of Overhall and Netherhall and ... Lavenham in ... Suffolk ... were purchased with the money of Master Alderman Skynner deceased ... and by his procurement so conveyed as that the same should be by him devisable by his last will and testament in writing'.[49] Thomas Skynner, Alderman and Lord Mayor of London, was well aware of the demands of the revenue, and said so expressly in his own will, leaving his lordship and manor of Campes in Cambridgeshire and Essex, together with the parsonage of Amwell, Hertfordshire, to descend to his son John Skynner 'to the intent the Queen's majesty shall be truly answered of her primer seisin and relief of all my lands tenements and hereditaments'.[50] Here, it seems, was no attempt to circumvent the revenue: it was made plain that sufficient was to be left to descend to answer the queen's entitlements.

But Alderman Skynner left himself room for manoeuvre. The manors of Overhall, Netherhall, and Lavenham were devised to his younger son Thomas, the will declaring the uses of the manors to Thomas and his heirs forever, with a similar devise of other land to his son Richard, with the proviso that because

> I can devise but two third parts of my lands and hereditaments to my younger children for that some part thereof is held in chief, therefore if my eldest son

[46] For example, in *Jermye v Styward* it was confessed in Chancery in 1599 that land was conveyed to the defendant in trust for Edward Stywarde 'for that the said Edward Styward had a rent of 20 marks a year issuing out of...the said lands and ... doubted if he should have taken the ... conveyance in his own name he should have extinguished ... his rent': C 33/97 f 228.

[47] For example in *Seymour v Blagrave*, one of the cases adduced by Barton, it was said in Chancery in the time of Elizabeth that Edward Seymour, Earl of Hertford, 'did ... commit trust unto ... Thomas Blagrave' for the purchasing of certain land 'to and for the use and behoof of the ... earl, whereupon ... Blagrave did take and receive the conveyance and assurance thereof unto himself and ... his heirs in his own name and yet did faithfully promise the said earl that he would within convenient time ... convey and assure the ... premises unto the ... earl and his heirs for ever'. Blagrave duly made a conveyance to the earl, the subsequent dispute in Chancery concerning an accompanying recognisance: C2 Eliz H24/25, undated, in the time of Bacon LK.

[48] See, for example, *Johnson v Stephens* (1591) C 33/81 f 492.

[49] C 78/127/6. For previous discussion of *Skynner's Case* see N.G. Jones, 'The Influence of Revenue Considerations upon the Remedial Practice of the Court of Chancery in Trust Cases 1536–1660' in C. Brooks and M. Lobban, eds, *Communities and Courts in Britain, 1150–1900* (1997), p. 99 at 106.

[50] PROB 11/89 q 51. Will dated 28 December 1596.

> or his heirs shall disturb any of my younger sons of or in any of the manors lands tenements or hereditaments that I have devised or limited unto them or either of them, then I devise two third parts of my foresaid manor and lordship of Campes … unto my two younger sons Thomas and Richard Skynner and to their heirs to be equally divided between them.

The land originally devised to Thomas and Richard, 'so conveyed as that the same should be by him devisable by his last will and testament in writing' seems likely to have been purchased in the names of others so that, if necessary, a further devise of two thirds of the land originally left to descend to the heir could be made to the younger sons without infringing the Statutes of Wills, a flexibility which would have been impossible had the land devised to the younger sons been land of which their father had died seised.

Alderman Skynner, it seems, sought flexibility rather than to circumvent the revenue. In contrast, in 1638 it was found in the Court of Wards that one Benjamin Maddox had purchased the manor of Little Bookham in Surrey, held *in capite*, in the names of four trustees, two of them holding the fee, and the others an estate *pur auter vie*, so that, as the reporter said, 'he had nothing except a trust'. Maddox then 'went into France shortly after the purchase' and there was, as the reporter put it, 'no colour to think that he wished to have the estate of the land in him to make a wardship which he had thought to prevent'.[51]

It is not known how common such arrangements were, though in contrast to the revenue questions posed by long terms of years, purchases in the names of others appear to have attracted relatively limited contemporary attention.[52] It may well be, as Barton suggested, that such purchases were frequently made secretly and without writing: '[t]here was' as he said, 'no point in providing evidence for the escheator',[53] and indeed in *Hill v Worth* it was observed by the court in Chancery in 1583, in response to an allegation of a purchase in the name of another, that 'if there were any such trust it might be so secret that no express proof … can be made thereof' other

[51] BL MS. Lans. 607, fo. 79v; WARD 9/100 f 371; WARD 9/552 pp 273, 287. See also N.G. Jones, 'The Influence of Revenue Considerations upon the Remedial Practice of the Court of Chancery in Trust Cases 1536–1660' in C. Brooks and M. Lobban, eds, *Communities and Courts in Britain, 1150–1900* (1997), pp. 105–106.

[52] For long terms see N.G. Jones, 'Long Leases and the Feudal Revenue in the Court of Wards, 1540–1645' (1998) 19 *Journal of Legal History* 1. The difficulties for the revenue posed by long terms of years turned upon the nature of terms of years as chattels real, which would not descend to the heir and so would not give rise to wardship, relief, or primer seisin. The reversioner had a freehold interest, but from the 1540s it was clear that the term would postpone a wardship of the reversioner's infant heir, leaving the king with the rent reserved upon the term, which might not represent the value of the land. In writing on long leases in the article above I spoke of their use to 'evade' the revenue. In the present context the use of the terms 'evade' and 'avoid' has itself been avoided: contemporary sources do not speak in such terms, and their use risks anachronism.

[53] Barton, 82 *LQR*, 225.

than by the oath of the alleged trustee.[54] The advantages of such secrecy are apparent, but there would be disadvantages too: trustees might misbehave, or, perhaps more likely, disputes might arise among potential beneficiaries after the purchaser's death. As the author of *Collections for the King's majesty's service* observed of purchases taken 'very secretly' or 'with no deed at all', 'because the matter is so secretly handled, the king is debarred ... and the subjects many times, go together by the ears for the land'.[55] There might be no point in providing evidence for the escheator, but, as Barton said, 'the need to avoid doing so would make the use of a trust that much more dangerous'.[56]

It has been seen that purchases in trust in the names of others were at times coupled with the grant of a long term of years from the trustees to the purchaser, a practice which may indicate the dangers of relying solely upon a trust. The significance to the revenue of long terms of years is borne out by Egerton LK's well-known dictum of 1597 that he would give '[n]o relief in equity touching leases of one thousand years, because they tend to defraud the crown'.[57] No similar statement is known in the case of purchases of land in trust in the names of others. The question would be likely to arise in two types of case, one perhaps more sensitive than the other: where the purchaser in the names of others was still living, and where he was dead at the time of the action.[58] Cases of the first type might require careful handling, and it seems probable that were it clear that the trust had been established to circumvent the revenue, a decree that the trustee convey to the purchaser would result, putting an end to the trust and bringing the land in question squarely within the scope of the Statute of Wills.

Cases of the second type might be less sensitive: the purchaser being dead, any scheme to circumvent the revenue would already have taken effect, for that generation at least. But proof of the trust in Chancery might

[54] C 33/65 f 598v.

[55] BL MS. Harg. 358, fo. 28.

[56] Barton, 82 LQR, 225.

[57] *Risden v Tuffin* (1597), Tothill 122; BL MS. Harg. 281, fo. 184; BL MS. Lans. 640, fo. 12v; BL MS. Stowe 572, fo. 73v; CUL MS. Gg.2.31, fo. 230. See also W.H. Bryson, ed., *Cases Concerning Equity and the Courts of Equity 1550–1660*, vol. 1 (Selden Society vol. 117) (2001), p. 264. It appears from the record that the defendant's name was Saffyn, and that the term was for 3000 rather than 1000 years as the reports have it: C 78/138/14, C 33/94 f 460. For further discussion of Egerton's approach to long terms of years see N.G. Jones, 'The Influence of Revenue Considerations upon the Remedial Practice of the Court of Chancery in Trust Cases 1536–1660' in C. Brooks and M. Lobban, eds, *Communities and Courts in Britain, 1150–1900* (1997), pp. 108–109.

[58] The question in cases of this second type might simply be a matter of misbehaviour by the trustees, but perhaps equally likely, if not more so, would be a question between the heir and devisees, as, for example, in *Baxter v Walker* (1588) where the matter was referred to Walmsley J. for arbitration: C 33/75 ff 599, 614, or a dispute in the absence of directions to the trustees, as, for example, in *Merick's Case* (1603) Cary 30.

nevertheless present an obstacle. So in *Blewett v War* (1594) it was found in Chancery that before his death Sir Roger Blewett had delivered £30 to the defendant to purchase certain land. The money seemed never to have been repaid 'and for that this court is something persuaded that the defendant was put in trust to purchase the premises for the said Sir Roger Blewitt albeit there is no such apparent proof thereof as this court may be induced to decree the ... land to the plaintiff', Sir Roger's son and heir, it was ordered that the defendant pay him £30.[59] Similarly, in *Hill v Worth* it was found in Chancery in 1583 that the plaintiff, alleging that John Worthe had been 'put in trust by the plaintiff's grandfather to buy [land] in the name of the ... grandfather and to his use', had 'not made any sufficient proof of the same trust'. Recognising, as has been seen, that 'if there were any such trust it might be so secret that no express proof other than the said John Worthe's oath can be made thereof', the court ordered John Worthe to be examined. He denied the trust, and the plaintiff was dismissed.[60]

The Chancery might also be inclined to allow land bought in the names of others to remain away from the beneficiary, upon payment of its value. In *Copleston v Beare* (1595) it was said in Chancery that the plaintiff's father had purchased land for £60 from one Rice, taking the assurance in the name of one Reddon in trust. Reddon had conveyed the land to the defendant 'being privy to the ... trust'. Counsel for the defendant did not deny 'but that in equity the ... plaintiff ought to be relieved either for the ... land or money'. The court therefore, thinking 'it not fit to alter the state of the ... land but that the same should rest where it now is', ordered the defendant to pay the plaintiff the £60 together and an additional £20 'for the forebearing of the said £60'.[61]

In the Court of Wards itself certain limitations upon the effectiveness of purchases in the names of others were recognised. Firstly, and perhaps most obviously, if a sole trustee died seised of the land leaving an infant heir, the king would have his wardship. So in *Gawber's Case* (1612) it was found in the Wards that Thomas, Earl of Dorset, had purchased land in 1600 in the name of John Gawber, who had subsequently died seised of the land, held by knight's service in chief, leaving an infant heir. Upon these facts it was resolved, perhaps with some reluctance, by the Chief Justices and the Chief Baron, 'that the heir of ... Gawber, ought to be in ward, and to sue livery, and that there is no remedy for it'.[62] But this cannot have been a serious pit-fall: as had long been the case, a well-managed purchase would include a number of trustees as joint tenants, so avoiding the possibility of a sole trustee dying seised.

[59] C 33/87 f 574v.
[60] C 33/65 f 598v.
[61] C 33/89 f 358.
[62] Ley, *Learned Treatise*, p. 40; BL MS. Lans. 607, fo. 29.

In the reverse, and presumably anticipated, case in which the purchaser died before the trustees, they might be left at the purchaser's death seised upon trust without a will declared directing the future disposition of the land. This situation had been considered well before the Statute of Wills: a statute of 1490 provided that in such a case the deceased beneficiary was to be treated for the purposes of wardship as though he had died seised.[63] This statute was considered in the Court of Wards in 1576 in *Brereton's Case*,[64] where the Master and Counsel of the Wards, with advice from the judges and the law officers, held that the inquisition after the death of one James Manley was insufficient to give the queen the profits of the lands in question, as

> there is not found that James Manley was seised or died seised of any use the day of his death, nor that the feoffees or any of the attorneys of them were seised to his use the day of his death, which ought to have been found in the said office because that by the common law the queen's majesty could not have the wardship of the heir of *cestui que use*, but the same wardship is given by statute made in the iiiith year of King Henry the viith,

and in consequence, it was held, a seisin to his use must be found expressly so that it might be traversed, and could not be supplied by implication.[65]

The issue of the wardship of the beneficiary of a trust arose again in the 1630s. In February 1637 three members of the Bedfordshire jury which had been sworn for the finding of an office after the death of one Lawrence Mathewe, appeared in the Wards to hear evidence on the question, *inter alia*, of whether Mathewe had

> died seised of a messuage and twenty acres of land in Harlington, and of one other messuage and 12 acres of land, which lands were formerly copyhold land parcel of the manor of Harlington, which lands were enfranchised and the said Lawrence had an assignment of a lease of the same for three score years, and after purchased the inheritance in the names of strangers in trust for him and such as he should name.

It was found that the manor of Harlington was held of the king by knight's service in chief, but, as concerning the question of a dying seised, 'because the same does arise from this point whether the heir of *cestui que trust* shall be in ward or not … and the counsel for the heir do desire to make a case upon the points in law', it was ordered that a case should be made, further directions to the jury to be given thereafter.[66] A case may have been made,

[63] 4 Hen. VII, c. 17.
[64] WARD 9/84 f 316.
[65] WARD 9/84 f 316.
[66] WARD 9/550 p 617.

but by August 1637 when a writ of *melius inquirendum* or a commission of that nature was issued into Bedfordshire to enquire better as to the tenure, the land was referred to as that 'whereof Lawrence Mathewe is found to die seised', and the escheator or feodary were admonished that should they 'perceive the jury inclined to find against his majesty contrary to their evidence then they are to forbear to accept their verdict and adjourn them over to a further day'.[67]

It is known that in the case of another mechanism which threatened the revenue, the Court of Wards had by 1611 adopted a policy that 'long leases by the general direction and order of this court are in all cases to be rejected and not to be found in any inquisition to be taken after the death of any of the king's tenants'.[68] Refusal to accept evidence that a tenant in chief had died possessed of a long term of years is a recurrent feature of seventeenth-century Wards practice, and it would come as no surprise if a similar assertion of control over evidence were found in the case of purchases upon trust in the names of others. We have seen that Benjamin Maddox purchased land in trust in the names of others, and that there was, as the reporter put it, 'no colour to think that he wished to have the estate of the land in him to make a wardship which he had thought to prevent'. But the device was defeated by the finding in the Wards, as the reporter put it,

> upon some scambling[69] proofs that Benjamin had declared in his life[time] that his trustees should re-convey to him and also that the trustees did seal a deed to Benjamin in his life[time] … and thus the court presumed that the trustees had re-conveyed to Benjamin in his life[time] … and directed the jury to find a dying seised … upon this presumption without any direct proof and contrary to the opinion of many.[70]

The jury had little choice: the escheator of Surrey had bound them over to appear in the Wards 'to hear their evidence at the bar of [the] court', whence they were dismissed to the county to 'find a dying seised accordingly and … no evidence shall be given to the contrary'.[71]

The evidence for the relationship between fiscal feudalism and the purchase of land in trust in the names of others is not plentiful. Further work on the record of the Court of Wards, and on the surviving conveyancing muniments, may reveal more. But the dictates of prudence may have rendered the

[67] WARD 9/550 p 1245.
[68] *Callowhill's Case* (1611) WARD 9/90 f 856; BL MS. Lans. 608, fo. 26v. For discussion of the practice of the Court of Wards in relation to long leases see N.G. Jones, 'Long Leases and the Feudal Revenue in the Court of Wards, 1540–1645' (1998) 19 *Journal of Legal History* 1.
[69] The meanings of 'scambling' given by the *Oxford English Dictionary* which may be applicable here are: 'contentious, rapacious', 'clumsily or carelessly executed, slipshod, slovenly; makeshift', 'irregular, rambling, scattered'.
[70] BL MS. Lans. 607, fo. 79v.
[71] WARD 9/100 f 371.

muniments a largely sterile source, and, at least in the seventeenth century, the Court of Wards seems to have been more concerned with the revenue difficulties of long terms of years, consideration of which was a recurrent feature of contemporary Wards business. This perhaps reflects the relative frequency with which long leases were employed in comparison with purchases in the names of others, though, as has been seen, the two devices might be employed in tandem. And if secrecy was a common feature of purchases in the names of others, such arrangements may not infrequently have simply eluded the revenue authorities.

But it does seem clear that purchases in the names of others gave those charged with the administration of fiscal feudalism cause for concern: in the time of Charles I a purchase in the names of others prompted the Court of Wards to consider the question, already old at the time of the Statute of Uses a century earlier, of 'whether the heir of *cestui que trust* shall be in ward or not',[72] and purchases in the names of others were, it seems, another context for that manipulation of evidence in the revenue's favour which is so apparent in the seventeenth-century Court of Wards in the case of long terms of years.

It seems clear also that Barton was right in suggesting that a purchase in trust in the names of others would take land beyond the scope of wardship and of the Statute of Wills, and that among the reasons for the creation of trusts of freehold land in the period was 'estate planning', the circumvention by purchases in the names of others of the 'land tax *faute de mieux*' constituted by the incidents of tenure. Such trusts were not infrequently in the form of a use upon a use: this is another situation in which that famous arrangement might arise.[73] But here, as elsewhere, it was only a matter of the conveyancer's choice in structuring the purchase: the key to the royal feudal revenue lay not in the scope of the Statute of Uses, by which trusts in the form of a use upon a use were untouched, but, as Barton himself suggested, in the wording of the Statute of Wills.[74]

[72] WARD 9/550 p 617.

[73] This would occur through a conveyance to trustees, expressed to be to the use of the trustees, but none the less upon trust for the purchaser, or through a conveyance to trustees by bargain and sale enrolled, or, indeed, as in *Gardner v Wayte* (1602) by a combination of both: C 78/103/16, C 54/1462 (enrolled deed of bargain and sale, dated 10 March 36 Eliz. (1594) on dorse of the roll).

[74] See note 42 above.

11

Stamp Duty, Propaganda and the French Revolutionary and Napoleonic Wars

LYNNE OATS AND PAULINE SADLER[1]

ABSTRACT

STAMP DUTY ON newspapers was introduced somewhat controversially in 1712, in the reign of Queen Anne, as part of a raft of revenue raising measures aimed at meeting the exigencies of the war of the Spanish Succession. The circumstances of its introduction are the subject of an earlier paper.[2] Despite initial enforcement difficulties and evidence of widespread evasion, the tax persisted, and over the course of the eighteenth century was subject to a number of modifications. The purpose of this paper is to explore developments in the newspaper stamp duty and associated taxes during the latter half of that century and early in the nineteenth century, the period following the French Revolution during which England was at war with France. When first introduced in 1712 it was primarily intended as a revenue raiser with censorship as a subsidiary, but not unintended, by product. The motivation for subsequent increases in stamp duty during the period under consideration is equally mixed, and difficult to discern.

BACKGROUND

The taxing of newspapers, directly and indirectly, is clearly related to other attempts to regulate the press. Certainly historians of the development of newspapers see the tax as being influential. A discussion of the newspaper

[1] Respectively: PhD, Lecturer, Warwick Business School; Visiting Research Fellow, Curtin University of Technology & PhD, Senior Lecturer, Curtin University of Technology; Honorary Research Fellow, University College London.
[2] Sadler, P. & Oats, L. This Great Crisis in the Republic of Letters *British Tax Review* (2002) 353–368.

taxes cannot therefore proceed, without also considering prevailing attitudes towards press freedom.

Politics and Censorship of the Press in the Eighteenth Century

Licencing of newspapers ceased in 1695, and from then England prided itself on having a free press subject to no formal government regulation. The content of newspapers might give rise to various criminal and civil offences, but, because the cause of action arose once publication had taken place, this was not seen as infringing press freedom. In the words of Blackstone:

> In this … where blasphemous, immoral, treasonable, schismatical, seditious, or scandalous libels are punished by the English law, some with a greater, others with a less degree of severity; the *liberty of the press*, properly understood, is by no means infringed or violated. The liberty of the press is indeed essential to the nature of the free state: but this consists in laying no *previous* restraints upon publications, and not in freedom from censure for criminal matter when published.[3]

In the first decade of the eighteenth century the issue of re–invoking some press licensing system was often debated. Indeed, when the stamp duty on newspapers was introduced in 1712, it was only because of the Chancellor of the Exchequer (who was also the Lord High Treasurer), Robert Harley (the Earl of Oxford), that a direct and wide ranging censorship of the press was not imposed instead. Harley persuaded the Tories, then in power, of the benefit of using a measure that would raise much needed revenue as well as making publication more difficult.[4]

It is beyond the scope of this paper to examine in detail the great changes in political thinking that occurred during the 18th century. For the purposes of setting the background to politics and the press during the French revolutionary and Napoleonic wars, the following is an extremely brief overview. After the glorious revolution in 1688, writers such as John Locke challenged previously accepted notions of the absolute nature of sovereign authority and power. In his *Second Treatise of Government*, published in 1690, Locke proposed something that was earlier unthinkable – he postulated that the people had a right to resist tyranny on the part of the sovereign. The 'sovereign' after 1688 was the king, or queen, in Parliament rather than an absolute monarch ruling with divine right. The eighteenth century thinkers David Hume, Adam Smith, William Blackstone and Edmund Burke accepted this approach, while others, who were more extreme in their

[3] W. Blackstone, *Commentaries*, (1765) Book IV, 151.
[4] J. Downie, *Robert Harley and the Press: Propaganda and Public Opinion in the age of Swift and Defoe*, (1979) Cambridge, 154–155; J. Black, *The English Press in the Eighteenth Century*, (1987) Beckenham, 11; C J Sommerville, *The News Revolution in England: Cultural Dynamics of Daily Information* (1996) Oxford.

views, took it further. Some of these even argued against a standing army as it might be used to enforce tyrannical rule.[5] During the course of the eighteenth century radical campaigners began to demand more rights for all men, which included an extension of the electorate and an extended franchise, on the basis of 'no taxation without representation'.[6]

Coupled with the developments in radicalism was the growth of the newspaper press. The relationship between the two was mutually beneficial, and the use of the press to publicise radical propaganda to the masses escalated greatly in the second half of the eighteenth century. The two fed off each other. Newspapers were also used to criticise government policy, especially during the wars of American independence [1775–1783]. According to Dickinson, more than a thousand different pamphlets discussing the American crisis came out of London in the 1760s and 1770s.[7] The actual number of newspapers printed does not bear any relationship to the ultimate readership. In London, and in the provinces, newspapers were shared, hired out or loaned, and as well they were purchased by public houses for customers to read.[8]

In the eighteenth century sales were insufficient to make a newspaper self-supporting, and many newspapers relied on outside funding to survive. Financial assistance might come from business or more likely from political parties, especially the party in power which would be keen to encourage favourable reviews of its performance. Not only radicals used newspapers to promote their particular version of propaganda. In some cases the amounts paid by the government to newspapers were huge; for example in the last decade of his ministry, during the 1730s–40s, Sir Robert Walpole spent over £50,000 of secret service money on pamphleteers and Treasury newspapers.[9]

Criticism of the government and government policies was irksome to those in power, but there was no return to licencing of the press to impose pre-publication censorship. There were, however, other ways to hinder the press. The public galleries in Parliament would be cleared to thwart the printing of parliamentary debates and the reporting of proceedings. This was especially true of the House of Lords which seemed more jealous of its privileges than the Commons. One member of the Commons complained that he had been described in print as 'little cocking George' and 'that little paltry, insignificant insect'. Authors or printers of adverse reports were summonsed before the respective House for breach of Parliamentary privilege.[10]

[5] H. T. Dickinson, *The Politics of the People in Eighteenth Century Britain* (1995) London, 171–172 especially fn 21.
[6] Dickinson, above n. 5 , 174–189, the quote is on p 178.
[7] Dickinson, above n. 5 , 240.
[8] M. Harris and A. Lee, *The Press and English Society from the Seventeenth to Nineteenth Centuries* (1986) London, 22–23.
[9] A. Aspinall, *Politics and the Press: c. 1780–1850*. (1973). Brighton, 66–67.
[10] H. R. Fox Bourne, *English Newspapers* (first published in 1887, reissued in 1966) New York, 209.

Finally a number of printers began to resist openly the attempts by Parliament to punish them. The situation came to a head in March 1771. Two London officials, Alderman Oliver and Lord Mayor Crosby, both members of the House of Commons, but who actively supported the printers, were sent to the Tower. As a result an angry mob bombarded ministerial members of Parliament and destroyed Lord North's carriage, injuring him in the process. Junius, an ascerbic commentator of current events, wrote, 'The triplet union of crown, lords and commons against England', and finished as 'an Englishman, and enemy of the cabinet therefore'.[11] Parliament was prorogued on May 8, and Crosby and Oliver released – but their imprisonment gave rise to a litany of criticism by the press that lasted the duration of their incarceration, and they were visited by a number of moderate politicians. Never again was there any serious attempt to prevent the reporting of Parliament, although the public galleries were cleared from time to time on sensitive occasions particularly when the American crisis was being discussed.[12]

In 1770 another fetter on the press arose as the result of a letter written by Junius and published by several London papers in late 1769. In *Letters of Junius No 35*, Junius openly criticised George III, beginning with the words:

> Sir, - It is the misfortune of your life, and originally the cause of every reproach and distress which has attended your government, that you should never have been acquainted with the language of truth, until you heard it in the complaints of your people.[13]

The letter was printed first in the *Public Advertiser*, published by Henry Woodfall. Woodfall was prosecuted for the criminal offence of seditious libel. The presiding judge was Lord Mansfield. Sensing that Woodfall would be acquitted, Lord Mansfield made his notorious direction to the jury stating that their role was simply to decide if the newspaper had in fact published the material. This direction thus reserved to the judge the decision as to whether or not the material was in fact defamatory, previously a matter for the jury to determine.[14] This had a great effect on the conduct of libel trials, because during the reign of George III most of these trials were used as a method of punishing political opponents of the government. Despite a lot of criticism, it was not until Fox's Libel Act was passed in 1792 that the jury's right to decide issues pertaining to the defamation itself was reinstated.[15]

[11] Fox Bourne, above n. 10, 215.
[12] Fox Bourne, above n. 10, 216.
[13] A. F. Pollard, *Political Pamphlets* (1897) London, 254–255.
[14] Fox Bourne, above n. 10, 204–204. F. Siebert, *Freedom of the Press in England 1476–1776* (1965) Urbana, 387.
[15] Fox Bourne, above n. 10, 229–230, 241. Seibert, above n 14, 391.

The other, even more insidious, method of silencing the press was to tax them out of existence through the stamp duties which are the subject matter of this study.

Stamp Duty on Newspapers

As noted above, the stamp duty on newspapers was introduced in the main as a means of raising revenue to fund the war of Spanish Succession. The stamp duty as originally levied in 1712 was at the following rates:[16]

For pamphlets and papers up to half a sheet	½d per copy
For pamphlets and papers more than half a sheet but not more than one sheet	1d per copy
For papers and pamphlets more than one sheet, but not more than six sheets Octavo (or 12 sheets Quarto, or 20 sheets Folio)	2s. per sheet on one copy.

In the case of pamphlets and papers of one sheet or less, the paper on which they were printed had to be stamped before printing. Pamphlets between one and seven sheets did not require pre-stamping, but had to be registered within specified time limits under pain of penalty of £20 for non compliance. Those comprising more than six sheets were not subjected to the stamp duty.

In addition, a stamp duty on advertisements was levied under the same Act at the rate of 1s per advertisement. Although denoted as a stamp duty, as with pamphlets of between one and six sheets, there was no requirement for actual stamping, however the administration of the tax was put in the hands of the Commissioners for Stamp Duties.

Amendment to the duty was made in 1724, in response to a prevalent avoidance practice which entailed increasing the size of newspapers to one and a half sheets so as to come within the concept of pamphlet, and thereby only be subject to duty on one copy, rather than on every copy, to which smaller papers were liable. The remedy under the 1724 Act was to declare that 'such journals, mercuries and newspapers, so printed on one sheet and half sheet of paper, shall not for the future be deemed or taken as pamphlets ... '[17]

While tackling cases of avoidance by increasing the size of publications, clearly the 1724 amendments did not operate so as to eradicate outright evasion of the newspaper stamp duty. By 1743 it had become necessary to

[16] 10 Anne c.19, CI.
[17] Geo I c.8.

enact legislation to allow for citizens' arrest of hawkers of unstamped papers.[18] The hawker could be committed to the House of Correction for three months, the person apprehending the hawker could claim a reward of twenty shillings, to be paid by the Receiver General of his Majesty's Stamp Duties.

The Seven Years War [1756–1763] 'gave a fresh impulse to journalism'.[19] Further amendments occurred in 1757 when the rate of duty on newspapers was increased by ½d.[20] Now the duty stood at 1d. The increase was to raise revenue for the war, and justified on the basis that in time of war people would pay more for information.[21] To accommodate the additional duties, and to prevent multiplication of stamps, the Commissioners were empowered to have a new stamp made to denote several duties. The Commissioners were required to 'keep separate and distinct account of the several rates and duties' and pay over funds, net of expenses, to the Exchequer. The Auditor of receipt was also required to keep separate account of the various duties. Penalties were applicable in the event of breach of trust or misapplication of monies by the Commissioners, and also for counterfeiting or forging stamps; the penalty for the latter being death without benefit of clergy.[22] In addition, the advertisement duty was doubled and extended to advertisements in periodicals and almanacs as well as newspapers.[23]

Interestingly it was due to the necessity of raising funds for the Seven Years War that the English Parliament attempted to impose the newspaper stamp tax on the American colonists. The duty, imposed by 5 George III, cap. 12, was repealed less than twelve months later by 6 George III, cap. 11 (dated 1 May 1766). The repeal followed violent resistance to the tax by the American colonists.

The 1757 increase in tax provided an incentive to paper makers to produce sheets as large as eighteenth century technology and manpower would permit. This was because the legislation failed to specify the size of sheet or half sheet which attracted stamp duty. At the time, the selling price of a newspaper of 2½d represented about 5 per cent of a London labourer's weekly wage, for an agricultural labourer it would be about 10 per cent.[24] In terms of the number of papers produced compared to the population, Barker suggests that at this time there were approximately 3 stamped newspapers produced for every two adults in Britain, compared to a ratio of 1:2 on the introduction of the newspaper stamp duty in 1712.[25]

[18] By 16 George II c. 26.
[19] S. Dowell, *A History of Taxation and Taxes in England*, (1884) London, Vol. IV, 354.
[20] 30 Geo II c. 19.
[21] Siebert, above n. 14, 320.
[22] 30 Geo II c. 19, XVIII, XXIII, XXV, XXVII. The quote comes from XXIII.
[23] 30 Geo II c 19.
[24] Barker, H. *Newspapers, Politics and English Society 1695–1855* (2000) Longman, Harlow, 39, by reference to Rule, J. *Albion's people: English Society, 1714–1815* (1992) Harlow.
[25] Barker, above n.24, 48.

The doubt as to whether papers of more than one and a half sheets were classified as pamphlets, which led to printers and publishers increasing the number of sheets to avoid the newspaper duty, was remedied in 1773. The boundary between newspapers and pamphlets was accordingly altered, to distinguish them based on content rather than size.[26] Now all 'journals, mercuries, chronicles and other public newspapers or papers containing public news, intelligences or occurrences' would be charged with newspaper duty regardless of size.

The rate of tax was increased in 1776, by an additional ½d. The duty on newspapers thus stood at 1½d for a sheet. This increase was precipitated by the American War of Independence and saw North, 'following the lead of Legge'.[27]

Notwithstanding the increases in newspaper taxes, newspaper circulation continued to increase. Harris, by reference to the stamp tax return records of stamps purchased, notes that 'the underlying pattern of growth [in newspaper circulation] that emerges therefore is of rapid growth to 1750, slower growth until 1780, then another take off into much quicker growth after that date.'[28]

Both Pitt and Lord North were of the view that papers were luxuries, thereby constituting appropriate fiscal targets. Indeed Lord North in 1777 said that demand for newspapers stemmed from 'idle curiosity'.[29] Pitt was a disciple of Adam Smith and many of his early proposals for alterations in the tax system reflected Smith's views from *The Wealth of Nations*.[30] The opposition Whig view, however, was that newspapers were not luxuries and that the government was interfering with the freedom of the press and putting newspapers beyond the reach of most citizens.[31] This latest increase in price resulting from the additional stamp duty meant that newspapers were probably beyond the means of those 'below skilled working class, in other words a majority of the population.'[32] The majority of newspaper purchasers would be from the middle classes. It must be remembered, however, that through the dissemination of news in coffee houses, taverns and ale houses, even the illiterate were able to keep abreast of events without actually purchasing the newspapers themselves.

Further amendments in 1789, this time not as a result of a war, both increased the tax and addressed some further avoidance practices.[33] Pitt was compelled to repeal his tax on shops and so sought recoup of the lost

[26] 13 Geo III c. 65.
[27] Dowell, above n 19, 355.
[28] Bob Harris, *The Press and Politics: Britain and France, 1620–1800* (1996) London, 12.
[29] Parliamentary Register viii, 55 26 November 1777, quoted in Aspinall, above n. 9, 9.
[30] Dowell, above n 19, 183.
[31] Aspinall, above n 9, 9.
[32] Harris, above n. 28, 15.
[33] 29 Geo III c. 50.

revenue by the extra tax on newspapers, in the face of stiff opposition.[34] The rate of newspaper duty was increased by a further ½d, and advertising duty was increased by 6d to 3s, a previous increase in 1780 had put the tax up to 2s.6d. These two measures were anticipated to produce revenue of £28,000 and £9,000 respectively.[35]

In addition, with effect from 1 August 1789, the Commissioners were no longer able to cancel the stamps on unsold newspapers, or to make any allowance for unsold newspapers. The practice that had evolved was to lend papers and then return them unsold. This was described by *The Times* as a 'practice not only a material hurt to the revenue, but likewise great injury to the proprietor.'[36] To combat the practice of newspaper hawkers letting out papers for small sums to be read by different persons instead of selling them, a fine of £5 was introduced.

On the eve of the war with revolutionary France therefore, the stamp duty on newspapers stood at 2d per newspaper, most of which were presented as four pages, printed on a single half sheet of paper. The advertisement duty was 3s. for each advertisement. There was no licensing of the press or other overt form of regulation. Dowell[37] presents the following table of the approximate yield of some of the principle taxes as at 1792–3, which indicates the enormous variety of objects of taxation and their respective yield:

I Direct taxes	
Land tax	2,000,000
Houses and establishments	1,300,000
Property insured from fire	185,000
Property sold at auction	75,000
Post horses, coaches, hackney coaches	277,000

II Taxes on articles of consumption.	
(e) eatables:	
salt	377,232
sugar	1,316,000
(b) drinks:	
Beer	2,224,000
Malt	1,203,000
Hops	151,000
Wine	1,016,000

(Contd.)

[34] Dowell, above n 19, 355.
[35] Dowell, above n 19, 193.
[36] Quoted in Aspinall, above n. 9, 16.
[37] Dowell, above n. 19, 207–8. The classification of the taxes shown is Dowell's, and not necessarily a reflection of modern classifications, nor of the way in which the government at the time presented the information.

Spirits	1,532,000
Tea	650,000
(c) Tobacco	566,551
(d) Articles not Eatables, Drinks or Tobacco:	
Coals exported and coastwise	700,000
Raw and thrown silk	300,000
Iron, bars	150,000
Hemp (rough)	103,000
Muslins	118,000
Calicoes	96,000
(e) Manufactures:	
Candles	256,000
Leather	281,000
Soap	403,000
Printed goods	265,000
Newspapers	140,000
Glass	183,000
Bricks and tiles	128,000
III Stamp Duties	
Bills and notes	156,000
Receipts	48,000
Consolidated duties	748,000

The notable absence is, of course, income tax, which was not introduced until 1799 after all other possible avenues for taxing the trappings of wealth had been exhausted. It was the view at the time that land tax, at the rate of 4s., could not be further increased and so Pitt had to subsequently resort to increasing the assessed taxes, excise duties and stamp duties adhering as far as possible to Adam Smith's view that the tax on the poorer classes should be kept to the barest minimum.

THE FRENCH REVOLUTIONARY AND NAPOLEONIC WARS

The revolutionary and Napoleonic French Wars were a series of wars fought against France by England, Austria, Prussia and others. The wars started in 1792 and continued effectively for some twenty years. In 1792 Austria declared war on France in an attempt to halt the French Revolution which began in 1789. Fox Bourne describes the start of the French Revolution as setting 'Europe in a flame from which than sparks fell upon England'.[38] As discussed earlier, by 1792 the newspaper press in England had already established itself as a method of communicating news and

[38] Fox Bourne, above n. 10, 242.

information to all classes of citizens. George III and his government had been openly criticised for its policies during the American crisis. The press, and in particular the radical press, informed the English people about developments in the French Revolution.[39] 'One of the reasons for increasing the newspaper stamp duty in 1789 was apparently Pitt's desire to hinder the press in this regard'.[40]

Pitt had tried to remain neutral in the face of 'harshly divergent attitudes towards the revolution ... expressed on the opposition benches in parliament by Charles James Fox and Edmund Burke'[41] but with the outbreak of war with France in 1792 he adopted a more repressive stance, within the constraints of existing mechanisms. Two proclamations were issued in 1792, urging 'magistrates to be watchful of seditious literature and to stamp out riot and agitation.'[42] During this year also, Paine's *Rights of Man* was published and widely distributed. The execution of Louis XVI in January 1793 became a potent source of propaganda. Many tracts and illustrations were produced depicting Louis XVI's last hours with his family and there were hopes among the opposition that it would provide a popular argument for entering into the war with France.[43] It was also seen as providing justification for the creation of Loyal Associations and 'underline the message of the two royal proclamations'.[44] Indeed, the depiction of Louis' last hours in narrative and picture continued for over a year. The government continued to use public funds to influence the press during this time, and secret service accounts for 1788–93 indicate that the majority of funds went to the press, although not necessarily on a regular basis, and also directly to writers for newspapers.[45]

Newspaper readership was not confined to literate purchaser of the papers, throughout the eighteenth century papers were acquired by publicans and coffee house proprietors where they were read to the clientele and thereby reached a much wider audience independent of literacy levels. The founder of the Loyalist Association in 1792, John Reeves, expressed concern about the prevalence of sedition in newspapers and published a pamphlet which encouraged 'all good subjects, whether Master or Private families, or Keepers of Inns, Taverns or Coffee Houses, to discontinue and discourage the use and circulation of all such disloyal and seditious Newspapers.'[46]

[39] Dickinson, above n. 5, 53.
[40] Fox Bourne, above n. 10, 244.
[41] F. O'Gorman, 'Pitt and the Tory Reaction to the French Revolution 1789–1815' in *Britain and the French Revolution: 1789–1815*, H.T. Dickinson ed. (1989) MacMillan, London, p 30.
[42] O'Gorman, above n 41.
[43] J. Barrell, *Imagining the King's Death Figurative Treason, Fantasies of Regicide* 1793–1796, (2000) Oxford, p74.
[44] Barrell, above n. 43, 74–5.
[45] Aspinall, above n. 9, 68–9.
[46] Barker, above n. 24, 139. The quote is taken from Kess, S *The Rise and Fall of the Political Press in Britain vol 1 The Nineteenth century* (1981) London, p156.

Concern about the increase in radical activity heightened, culminating in new legislation enacted in 1795 with the aim of stamping out radicalism. In May 1794, the government had suspended Habeas Corpus and now two pieces of legislation were enacted, the Treasonable and Seditious Practices Act which redefined treason, and the Seditious Meetings Act which banned meetings of more than 50 people. The concern about the harmful nature of newspapers continued, in 1795 the Whig writer Vicesimus Knox wrote:

> Perhaps there is nothing which contributes so much to diffuse the spirit of despotism as venal newspapers, hired by the possessors of power, for the purpose of defending and prolonging their possession. The more ignorant classes have a wonderful propensity to be credulous in all that they see in print and will obstinately continue to believe a newspaper, to which they have been accustomed, even when notorious facts give it the lie.[47]

Increases in Newspaper and Advertisement Duties in 1797

It was against this background, together with increasing need for additional revenue,[48] that further increases in the stamp duty on newspapers were enacted in 1797. As part of the budget, Pitt announced a number of tax increases. In the Commons debate in April 1797, Pitt, at the time Chancellor of the Exchequer expressed his anxiety over the selection of appropriate objects for taxation and said 'I have been activated by the desire of making [the additional taxes] fall as lightly as possible on the great sources of national industry and on the lower orders of people'.[49] He targeted stamp duties generally as being preferable as a source of taxation on the basis that they were 'easily raised, widely diffused', and 'pressed little against any one particular class, especially the lower orders of society, and at the same time ... was ample, was safely and expeditiously collected at a small expense.'[50] He proposed the greatest increase to apply to consolidated stamp duties, that is those applicable to a range of different instruments, but also

[47] Barker, above n.24. The quote is from Knox, V. *The Works of Vicesimus Knox* (7 vols) (1824) London, 174.
[48] Dowell (above n.19, 209) notes that the 'Great War' that is, the war with revolutionary France and the subsequent war with Napoleon, proved more costly than all other preceding wars taken together.
[49] Parliamentary History, vol 33 (1797), 423. It must be noted that reliance on published accounts of parliamentary speeches at this time is hazardous. While reporters were allowed access to the debates, they were not allowed to write anything down, and relays of reporters attended parliament and then later wrote their recollections for publication. Ministers were often also allowed access to their speeches prior to publication for judicious editing. See Barker, above n. 24, 91, for some examples.
[50] Parliamentary History vol 33 (1797), 432.

proposed an increase in the newspaper stamp duty, anticipating 'a great deal of discussion out of doors' on this issue.[51]

Pitt was of the view that newspaper stamp duty might 'fairly be converted into an additional source of revenue without hurting the proprietors or editors, and without any oppression to the community.'[52] The stamp duty on newspapers at the time was 2d and most papers charged 4d. The increase which Pitt proposed, and was eventually imposed, was 1½d which he calculated as producing £114,000 per annum by way of additional revenue. He was concerned that 'the public should derive all the advantage of an addition to the price' and so offered a discount to the newspapers which only increased the price of their papers by the amount of the duty. The discount then stood at 16%, although the old discount of 4% was still available for those who failed to keep their price to 6d or below.

Consideration was also given to changes to the advertisements duty at this time. The duty was a flat rate, irrespective of the size of advertisement. Pitt noted that different prices were charged by the papers for advertisements depending on their length, with variation between 4s and £4. He noted that the public derived no advantage from this with a flat rate of advertisement duty, and proposed a scale for the duty which would generate additional funds of £20,000 per annum.[53] This measure did not pass into legislation, the reasons for which are not reported in the Parliamentary Debates.[54]

The Opposition, as was usually the case, interpreted the increase stamp duty on newspapers as an attack on press freedom. Mr Sheridan described the taxes as 'frivolous and vexatious' and predicted that they would 'prove oppressive and unproductive.'[55] He regarded the tax on newspapers 'as a vital blow struck at the liberty of the press … by putting the information conveyed in them at a price beyond the reach of the majority of the public.'[56] While the government justified the tax as being on an item of luxury, Sheridan scathingly retorted 'was the dismal catalogue of miseries which they now contained a luxury to those by whom they were read?' He further said that the tax would have the effect of destroying cheap publications 'for the instruction or information of the public' implying that as being an ulterior motive of the government.

Despite the Opposition's protest, the legislation was passed and the stamp duty on newspapers now stood at 3½d. The pamphlet duty remained unchanged at 2s and the advertisement duty 3s.

[51] Parliamentary History vol 33 (1797), 433.
[52] Parliamentary History vol 33 (1797), 433–4.
[53] Parliamentary History vol 33 (1797), 433–4.
[54] Aspinall, above n. 9, 19.
[55] Parliamentary History vol 33 (1797), 441.
[56] Parliamentary History vol 33 (1797), 441.

Further 'Impositions' on the Stamp Office

In 1797 legislation was also enacted 'for preventing the mischiefs arising from the printing and publishing newspapers and papers of a like nature, by persons not known, and for regulating the printing and publication of such papers in other respects.' [57] The Newspaper Regulation Act prevented the printing or publishing of 'newspapers or other papers containing public news or intelligence or serving the purpose of a newspaper' without prior delivery of an affidavit or affirmation to the Commissioner of Stamp Duties. The affidavit or affirmation was to specify the 'real and true names, additions, descriptions, and places of abode of all and every person or persons, who is and are intended to be the printer or printers, publisher or publishers, of the newspaper or other paper.' Proprietors were also to be named, together with their ownership shares in the newspapers and details of the title of the newspaper and the place of printing.[58] Further affidavits or affirmations were required whenever a change of abode occurred or at the request of the Commissioner for Stamp Duties.

Where papers were published in the absence of an affidavit or affirmation, a penalty of £100 could be imposed on each occasion.[59] The penalty for false or imperfect affidavits or affirmations was set as equivalent to that for wilful and corrupt perjury.[60]

In addition to notifying the Commissioner for Stamp Duties, newspapers were also required to contain 'the true and real names' and places of abode of the printer(s) and publisher(s) and the place of printing, failure to do so attracting a penalty of £100. [61] With effect from 1 July 1798, the printer or publisher of every newspaper or like paper was required to deliver to the Commissioner of Stamp Duties, within six days, a signed copy of the paper, penalty for failure to do so was also £100.[62] Interestingly, the Commissioner for Stamp Duties was required to pay the 'ordinary' price for the paper.

The act also provided for penalties for publication of unstamped newspapers, being £20 for every paper not duly stamped.[63] A £20 penalty also applied to persons in possession of an unstamped paper[64] and for sending an unstamped paper overseas, the latter attracting a £100 penalty.[65]

A further penalty, a hefty £500, applied were 'any person, during the continuance of the present war, shall knowingly and wilfully, directly or

[57] 38 George III cap 78.
[58] 38 George III cap 78 II.
[59] 38 George III cap 78 VII.
[60] 38 George III cap 78 VIII.
[61] 38 George III cap 78 X.
[62] 38 George III cap 78 XVII.
[63] 38 George III cap 78 XVIII.
[64] 38 George III cap 78 XIX.
[65] 38 George III cap 78 XX.

indirectly, send or carry, or endeavour to send or carry, or cause or procure to be sent or carried or do or cause to be done, or be in any manner concerned in doing or causing to be done, any act whatever, for or towards the sending or carrying, or for or towards the causing and procuring to be sent or carried, or with intent that the same should be sent or carried, any newspaper, or other such paper ... whether printed upon paper stamped or not stamped, out of Great Britain into France, Spain, or any other country not being in amity with his Majesty, at the time of such act done or permitted to be done.'

Any person possessing a newspaper intended to be sent to hostile countries could be summoned and examined by a Justice of the Peace as to whether they had accomplices.

Another clause dealt with the perceived threat of publication of invective allegedly having been published abroad. 'And whereas matters tending to excite hatred and contempt of the person of his Majesty, and of the constitution and government established in these kingdoms, are frequently published in newspapers or other papers, under colour of having been copied from foreign newspapers'.[66] Any persons printing or publishing in England (not the whole of Great Britain), any such matter not having previously been published overseas, was, on conviction, to be committed to prison for between six and twelve months. The onus of proof was on the defendant.

Finally, restrictions were placed on the provision of stamped paper,[67] by requiring that pre-stamped paper for the printing of newspapers only be delivered to persons known to the Stamp Office. Unsurprisingly the Commons debate of this legislation was vitriolic. Commenting on the expected negative outcome of the legislation, Mr Jeckell said 'This bill would make men of property and responsibility retire from newspapers altogether, and they would then fall into the hands of men of desperate fortune and low character. The consequence would be an increase in stead of a diminution of the licentiousness of the press.' The Attorney General stressed that his object 'was not to infringe on the liberty of the press, but to restore it.'[68]

Aspinall[69] comments on the inequities of the legislation in targeting proprietors of newspapers when they didn't necessarily have control over the content of the papers. The definition of publisher was so broad that it could conceivably extend to a humble newsvendor who was actually illiterate. According to Collett 'The object of these securities was not to bring a number of opponents of Government to utter grief, but to suppress all expression of discontent. Any man who carried on printing or publishing

[66] 38 George III c. 78 XXIV.
[67] 38 George III c. 78 XXVI.
[68] Parliamentary History vol 33 (1797), 1482.
[69] Aspinall, above n. 9, 38.

for a livelihood was actually at the mercy of the Commissioners of Stamps, when they chose to exercise their powers.'[70] This is a particularly interesting development, in that while it did not affect the assessment and collection of stamp duties, it imposed additional administrative requirements on a government department to achieved aims totally unrelated to revenue collection.

According to Collett, 'the Newspaper Stamp had now been imposed for eighty seven years, and Parliament had come to consider every printer as the raw material of a traitor.'[71] This somewhat overstates the position, however, as the mechanisms adopted to curb the press were in reality mild. Despite discussions between 1792 and 1799 relating to tightening statutory control over the press, the only measures adopted are those discussed which in effect did little to curb the press as a whole, although it did seem to serve to dampen the radical press prior to the turn of the century.[72]

The various taxes on newspaper, the stamp duty and advertisement duty together with the excise duty on the paper on which newspapers were printed, severely impacted on pricing. Newspapers were 'taken up in a spirit of duty and read religiously. Inevitably, [they] became progressively blacker in appearance as taxes were increased and space became more and more valuable.'[73] Thus, an inadvertent consequence of the stamp duty was its impact on the physical appearance of newspapers during the eighteenth century.

AFTER THE PEACE OF AMIENS 1803–1815

Following the increases in the stamp duty on newspapers and advertisements in 1797, no further change was made to the rate of duty until towards the end of the Napoleonic wars in 1815. The significant increases in prices generally during the Revolutionary and Napoleonic wars impacted on newspaper production, however, and in 1809, by concession, the discount on bulk purchase of stamps, introduced in 1797 and increased in 1804, previously only available to those who did not increase their prices above the 1797 level, was extended to all.[74]

Curran notes that when radical papers began to appear in the Napoleonic War, they 'were immediately recognised by the ruling class as a threat to social order. Official reports that radical papers were being read

[70] C.D. Collett, *History of the Taxes on Knowledge*, (1899), London, 14.
[71] Collett, above n 70, 16. It must be borne in mind that Collett was later one of the Chartists who campaigned vigorously for the repeal of the 'Taxes on Knowledge' in the mid 1800s and therefore had a somewhat jaded view of the legislation.
[72] Barker, above n. 24, 69.
[73] S. Morison, *The English Newspaper*, (1961) London, 206.
[74] Aspinall, above n. 9, 19.

by common soldiers and servants below stairs in the great houses of England were the subject of anxious parliamentary discussion, fuelling fears of armed insurrection. While this concern was alarmist, there can be no doubt that the extension of the radical press to a growing lower-middle class and working class audience did constitute a threat to social stability. Radical papers mercilessly lampooned the dominant ideology of a divinely ordained natural order as a fairy tale invented by the rich to cheat the poor.'[75]

Newspaper circulation continued to grow steadily and newspaper production became an increasingly profitable activity. By the turn of the century, there were approximately 3 stamped newspapers produced for every adult in Britain, compared with 3:2 in the 1760s.[76] Barker denies that the growth is explained purely in terms of its connection with prevailing political turmoil and suggests that a combination of factors, including improved technology in the production process, contributed to the growth throughout the late 1700s and early 1800s.[77] In 1807, William Cobbett said:

> If ever there was in the world a thing completely perverted from its original design and tendency, it is the press of England: which instead of enlightening does, as far as it has any power, keep the people in ignorance; which instead of cherishing notions of liberty, tends to making the people slaves; and which instead of being their guardian, is the most efficient instrument in the hands of those who oppress, or who wish to oppress them.[78]

Although the radical press had been largely silenced in the mid 1790s, it would reappear after 1800, with increased vigour. A number of papers attacked the war, the *Manchester Gazette* for example in 1800 noted:

> Glory … never cultivated a yard of land, never added a grain to the poor man's loaf, nor put an ounce of warp into the poor man's loom; … Can stabs with the bayonet, can limbs blown from the body by gunpowder, can brains scattered by cannonballs, can the agonies of ten thousand men, oppressing the bare earth with horror, staining the rivulets with blood, writhing, groaning, and dying, can the inclemencies of the sky, the damps of the marshes, the agues, fevers and consumption of unsheltered ditches, can the pestilence, fire, frost and famine, increase the sum of human happiness?[79]

[75] J. Curran, 'The Press as an Agency of Social Control', in G. Boyce, J. Curran and P. Wingate eds *Newspaper History from the seventeenth century to the present* day, (1978) London, 64.
[76] Barker, above n. 24, 46.
[77] Barker, above n. 24, 37.
[78] Barker, above n. 24, 19. The quote is taken from Jones, A. *The Powers of the Press: Newspapers, Power and the Public in Nineteenth Century England.* (1996), 31–3.
[79] Barker, above n. 24, 189. The quote is taken from Smith *English Radical Newspapers*, 51.

Despite this, there was no return to direct government control of the press. During the Napoleonic wars there was no censorship of the news, and strategic information that was to the disadvantage of England appeared in print on more than one occasion. Stories appeared in English newspapers that compromised the English position and English prisoners in France, and there were even suggestions in the French Parliament that English newspapers were in the pay of the French government.[80] In 1812 the Duke of Wellington complained to his brother, Lord Wellesley, that he would succeed in his next campaign 'unless those admirably useful institutions, the English newspapers, should have given Bonaparte the alarm, and should have induced him to order his marshals to assemble their troops to oppose me'.[81] In contrast the press in countries forming the Holy Roman Empire was subject to censorship of a greater or lesser degree[82] and the French press existed only under official supervision.[83]

The press continued to be manipulated for political ends. The impeachment of Lord Melville, charged with misappropriation of public funds, provided the Opposition with the chance to undertake a propaganda campaign and so proceeded to invest funds in an anti government press campaign. The 1807 General Election provides further examples of political influence over the press.[84] There is also an argument that the spread of Luddism in 1811–12 can be attributed, at least in part, to newspaper stories.[85]

In 1815, despite the end of hostilities, further increases were made to the newspaper stamp duties. The Chancellor of the Exchequer had intended imposing an additional tax of 1d on each newspaper but met opposition on the basis that it would disadvantage circulation of newspapers. Similarly, an increase in the duty of advertisements according to their length was opposed by the editors of the newspapers who preferred an additional ½d on each paper and 6d on each advertisement.[86] Out of concern for profiteering through proprietors of papers increasing the price of papers beyond the amount of the increased stamp duty, an additional discount was allowed to those who increased the price of their papers from 6½d to 7d. The Chancellor suggested that 'no duty would be more cheerfully paid by the public than an increase of one halfpenny on the price of a newspaper' as their sale depended 'almost wholly on the situation of public affairs, and as at the present time, and probably for some years to come, a laudable curiosity would be directed to the events which

[80] Aspinall, above n. 9, 34–35.
[81] Cited in Aspinall, above n. 9, 34–35.
[82] A. Smith, *The Newspaper: An International History*, (1979) London, 63–65.
[83] Smith, above n. 82, 47–48.
[84] Aspinall, above n. 9, 284–5.
[85] Barker, above n. 24, 193.
[86] Parliamentary Debates vol xxxi London (1915), 661.

were passing.' The additional price 'on the publications through which the public derived their information would not be grudged by the purchasers.'[87]

> In opposing the increase, Sir John Newport said that 'it was of the utmost importance to the public that this channel of general information should be as free as possible to the community at large.'[88] He protested on the grounds of equity, that it was unfair to exploit the public's demand for information, and referred to the superior newspaper circulation in America where there was no stamp duty. In support, Mr Ridley, an Opposition member, said that while he had no objection to the tax on the basis of its effect on proprietors, he did object on the basis of diminished circulation of information. Somewhat curiously, though, he did support the increase in the advertisement duty on the basis that in his experience it represented only a small proportion of the charge for placing an advertisement.[89]

In the House of Lords, Earl Stanhope noted that previous experience had shown that such increases in taxes actually had the effect of diminishing revenue and so he expected the increase in newspaper stamp duty to be similarly counter productive. He further opposed the measure on the basis of it constituting an impediment to the freedom of the press, and expressed the view that the measures were not only 'objectionable in character, but absurd in [their] construction.'[90]

The Times referred to the increased duties as 'obnoxious and prejudicial' stating that newspapers should not be viewed as luxuries, but rather as performing an important function of information dissemination among the middle classes.[91]

A number of papers expressed concern that the increased duties would see the demise of a number of papers. According to the *Morning Chronicle* of 3 June 1815, the additional tax was 'calculated to oppress if not finally crush those independent newspapers who rest upon public opinion only for protection, and not on Treasury favour.'[92]

And on 9 June 1815, nine days before the battle of Waterloo, *the Times* reported:[93]

> Mr Vansittart thinks a newspaper a mere luxury. Perhaps it is to him, but he knows nothing of the commerce of the country in its numerous details and

[87] Parliamentary Debates vol xxxi London (1915), 661.
[88] Parliamentary Debates vol xxxi London (1915), 661.
[89] Parliamentary Debates vol xxxi London (1915), 663.
[90] Parliamentary Debates vol xxxi London (1915), 1141.
[91] Aspinall, above n. 9, 20.
[92] Quoted in Aspinall, above n.9, 22.
[93] Quoted in Aspinall, above n. 9, 21.

> ramifications; he knows nothing of the anxieties of relations and friends for those who are engaged in warfare, or who travel by land and sea, if he cannot see in a newspaper something far different from and far more sacred than mere idle recreation.

At this time a newspaper cost 7d which represented approximately between 6 and 12% of a rural labourer's wage, about 2% of the weekly wage of a London artisan, cheaper in fact as a proportion of wages than papers were in 1757.[94]

Other taxes imposed or increased in the last year of the Napoleonic war include excises on liquor, tobacco, soap, candles, glass, tax on legacies and successions to personal estates, property insured from fire or sea risk, stage coaches, gold and silver plate and stamp duties on almanacs, bills and notes, legal proceedings, receipts and deeds and instruments.

CONCLUSION

The flurry of radicalism in the early 1790s, in the aftermath of the French revolution and in the early stages of the revolutionary wars, was of concern to the government who were at pains to prevent any semblance of revolutionary fervour spreading to Great Britain. A variety of legislative measures were introduced, suspension of Habeas Corpus, the Treasonous and Seditious Practices Act and the Seditious Meetings Acts of 1795, the Newspaper Regulation Act in 1797 and the Combination Acts of 1799 and 1800 were all aimed at suppressing radical tendencies. It was in the midst of this legislative activity that significant increases in the newspaper stamp duty occurred in 1797. The conclusion seems inescapable therefore that the stamp duty was used as an alternative mechanism for placing fetters on the liberty of the press, and certainly this is the interpretation that the Opposition benches placed on the increases.

It must be remembered, however, as was the case when the newspaper taxes were first introduced in 1712, that this was also a period of enormous revenue needs to fund the military activity. The tax was one of many that were introduced or increased over the course of the wars and it is equally possible that the motivation for the increases in 1795 and 1815 were purely fiscal.

The impact of the newspaper taxes on the development of newspapers is interesting; in order to minimise the tax, papers adopted a format in the 1760s which was then perpetuated until the early 1800s, four pages on a single half sheet of paper, as large as possible within the constraints of the

[94] Barker, above n. 24, 39, by reference to Rule, J. *Albion's people: English Society, 1714–1815* (1992) Harlow.

technology available, containing four columns of tightly packed text with little in the way of 'signposts' such as headings and sub headings. The tax also seems to have hindered growth of newspapers in terms of their circulation. Whilst the British press enjoyed substantial freedom compared to their European counterparts, the price of newspapers was inflated considerably by the newspaper stamp duty and associated taxes.

12

Slave Taxes

KEVIN OUTTERSON[1]

Taxes are what we pay for civilized society,

Oliver Wendell Holmes[2]

ABSTRACT

OVER THE PAST decades, economic historians have fruitfully engaged the topic of slavery, particularly the Atlantic slave system and North American slavery. We now have a clearer picture of the movement of slaves, their economic status at various times and places, and the economic systems which supported and benefited from slavery, including the trading interests in cities such as Liverpool and Boston. Likewise, legal historians have published voluminously on the legal structures of slavery and antislavery. One area of comparative neglect is the intersection between the two: the place of slavery in the tax law and revenue systems of governments.

This paper begins that project, examining the role of slave taxes in governmental finance, particularly in colonial and antebellum America, and linking this research with the broader debate over reparations for slavery.

During the eighteenth and nineteenth centuries, state, local and national governments taxed slaves and slave commerce. Slave Taxes[3] proved to be very valuable: from Colonial times to the Civil War, American governments derived

[1] Kevin.Outterson@mail.wvu.edu. I thank the College of Law at West Virginia University and the Hodges Grant for their financial support of this project.

[2] *Compania General de Tabacos de Filipinas v Collector of Internal Revenue*, 275 U.S. 87, 100 (1927) (Holmes, J., dissenting).

[3] In this essay, the term 'Slave Taxes' will refer to direct taxes on slaves (poll and capitation taxes; property taxes; impost duties; and occupational taxes); indirect taxes on slaves (taxes on slave transfer and manumission; and discriminatory taxes in the slave era on free blacks); and taxes on slave commerce (export duties on slave commodities such as tobacco, cotton, and rice; import duties on articles purchased with slave commodities; and ad valorem taxes on slave improvements such as houses built by slaves and land improved and worked by slaves). The term as used herein is thus much broader than the federal direct slave tax of 1798 or state poll taxes on slaves. One important and controversial aspect of this definition is that it specifically includes that portion of federal customs revenue on imports made possible by the export of slave commodities.

more revenue from Slave Taxes than from any other source. Given the uncivilized treatment of slaves in America, perhaps a refund is due.[4]

If this essay is successful, it will begin a debate and illustrate the type of research which could be pursued under a federal reparations study commission.[5]

I. SLAVE TAXES AND BLACK REPARATIONS

Reparations have been paid to many groups over the past 60 years. A partial list would include: Japanese-Americans interned during World War II; the State of Israel by the Federal Republic of Germany; Swiss banks to Holocaust-era depositors; German and Italian insurance companies for Holocaust-era policyholders; German companies to industrial war slaves; Maori restitution by New Zealand; multiple suits and settlements involving indigenous peoples in the United States; and Korean sex slaves in Japanese occupied territory.[6] To this list I would add affirmative action, which was originally defended as redress for slavery and discrimination.

Many of the arguments currently offered to oppose black reparations have been successfully resolved in the reparations listed above. These arguments include sovereign immunity (waived by Germany, New Zealand, the U.S. in Japanese-American redress and in Native American settlements, and to a very limited degree by Japan); the fairness of imposing the burden of reparations on a later generation (all cases); the methodology for documenting

[4] I do not suggest filing a refund claim with the Internal Revenue Service just yet, for many important legal questions would first have to be resolved. Initially, it must be acknowledged that rarely did the slaves themselves pay any Slave Taxes. In the ordinary course, the masters paid the tax on his property. Other obstacles include sovereign immunity, the statute of limitations, the lack of a procedure for refunds of this nature, and the lack of adequate documentary records. IRS officials have warned against filing 'slave reparations' refund claims, which are viewed as an illegal tax scam. J.J. Thompson, *IRS Officials Warn of 'Slave Reparations' Tax Scam*, Phil. Inquirer, Oct. 15, 2000 *available at h*ttp://inq.philly.com/inquirer/2000/10/15/south_jersey/15jscam.htm (visited July 10, 2001); Michelle Singletary, *'Slave Reparation' Tax Scam Targets Blacks*, Seattle Post-Intelligencer, March 5, 2001 *available at* http://seattlep-i.nwsource.com/money/sing053.shtml (visited July 10, 2001).

[5] *See, e.g.,* Commission to Study Reparation Proposals for African-Americans Act, H.R. 40, 107th Cong., 1st Sess. (2001). This legislation has not been passed by Congress. For a successful prior effort to create a similar commission, *see* Commission on Wartime Relocation and Internment of Civilians Act, Pub. L. No. 96–317 (1980) (established study commission for persons of Japanese ancestry who were interned by the U.S. government during World War II) (for background, *see Korematsu v United States*, 323 U.S. 214 (1944); *Hirabayashi v United States*, 320 U.S. 81 (1943); and *Yasui v United States*, 320 U.S. 115 (1943). The Report of the Commission on Wartime Relocation and Internment of Civilians led to the passage of the Civil Liberties Act of 1988, Pub. L. No. 100–383 (1988) (Congress accepted the findings of the Commission) and subsequent appropriations. Mitchell T. Maki et al., Achieving the Impossible Dream: How Japanese Americans Obtained Redress (1999).

[6] *See generally* Elazar Barkan, The Guilt of Nations (2000).

claims without strict legal proof (all cases); and tailoring the reparation to the crime and the needs of the population (all cases). Even the most ardent opponent of black reparations should admit that slavery was a crime against humanity. The Holocaust was sufficient to overcome these barriers to reparation; slavery and its aftermath deserve the same evaluation.

And yet the black Reparations Movement faces daunting prospects. Congress has been reluctant to even study the issue. What is different about black reparations that makes the nation shrug rather than acknowledge responsibility? Why can't the nation take the bare minimum step to study the question in a federal reparations study commission?

Three arguments emerge as likely explanations. First and foremost, the argument goes, slavery was a long time ago, ending with the Civil War. All of the people involved are dead and it wouldn't be fair to visit the sins of the fathers on the great-grandchildren, or to reward people whose ancestors were slaves.

The second argument takes a different tact: it acknowledges that slavery and discrimination were evil, but argues that the debt has been paid, namely by the Civil War, emancipation, the New Deal, the Great Society and by affirmative action. Another version of this argument says it would cost too much to pay adequate black reparations.

The third argument is a holdover from the Middle Ages: sovereign immunity, the King can do no wrong. In slavery, the governments and peoples of Europe, America, Asia and Africa committed grievous wrongs. To say that sovereign immunity prevents discussion of black reparations is disingenuous. Waiver of sovereign immunity is a political act, as it was in many of the reparation claims mentioned above, and building political consensus for a waiver requires factual analysis and discourse. These are the goals of a federal reparations study commission. In any event, sovereign immunity may already have been waived in this case, particularly since slavery and the slave trade was recognized as a crime against humanity. The U.S. government has previously invoked this principle from a position of righteousness. Now the shoe is on the other foot.

This essay is designed to respond primarily to the first argument. While the individuals involved may all be dead, some legal persons remain, particularly governments and corporations which benefited from slavery. Despite the passage of time, these beneficiaries of slavery are still among us, and could face legal claims for their complicity.[7] If a government benefited from a crime against humanity, it should be held responsible.

[7] Legal action against corporations avoids the difficult questions of sovereign immunity. My preference is for a political and factual discussion of black reparations rather than a series of class action lawsuits. If the wound in American society is racial, legal approaches may polarize rather than encourage positive societal transformation.

II. SLAVE TAXES IN AMERICAN GOVERNMENTAL FINANCE

A. The Beginning of Atlantic Slave Taxes

The first English Atlantic slave voyage was Sir John Hawkins' expedition in 1562–1563, capturing 300 Africans.[8] The English Crown chartered companies in the seventeenth century to bring slaves to English colonies in the New World.[9] The English were latecomers to the slave trade. The Portuguese pioneered the Atlantic slave trade in the fifteenth century, establishing their first post on the Gold Coast in 1482, followed by the Spanish. These governments profited from the granting of trade company charters as well as direct investment in slave trading. Spain also imposed taxes at the rate of twenty percent on some slaver voyages in the late fifteenth century.[10]

In the late sixteenth century, other foreign powers, notably Dutch private traders, joined the Portuguese and Spanish in the Atlantic slave trade. The first Dutch West India Company, chartered in 1621, paid a dividend to each of the town councils comprising the Netherlands as a form of tax. By the 1660s, the English, Danes, Swedes, French and Germans had joined the Dutch, Portuguese and Spanish in the struggle for control over the African trade,[11] with the participation of some African nations.[12] None of the European nations were able to establish a monopoly on the African trade, although they were able to capture significant tax revenues.[13] At that time, the slave trade to North America was just beginning. As the Atlantic slave trade approached its 150th anniversary, the vast majority of the slaves of African origin in the New World were in Brazil, Mexico, Peru and the Caribbean Islands, producing sugar, silver and gold for export to Europe.[14]

Spain used its New World colonies to raise revenue. In 1713, Spain sold the monopoly on the Spanish colonial slave trade to the Royal African Company for 200,000 crowns plus a duty of 33½ crowns per slave imported. The plan required the importation of at least 144,000 African

[8] James Walvin, Black Ivory: A History of British Slavery 25 (1992).

[9] The Royal African Company, chartered in 1672 by Charles II, was the first to meet with success. It was preceeded by the Company of Royal Adventurers trading to Africa in 1662 and a prior company chartered by Charles I in 1631.

[10] Martina Elbl, Portuguese Trade with West Africa, 1440–1520 340–41(1986) (unpublished Ph.D. dissertation, University of Toronto) *cited in* John Thornton, African and Africans in the Making of the Atlantic World, 1400–1800 58, n.48 (2d ed., 1998).

[11] John Thornton, Africa and Africans, at 63–64.

[12] John Thornton, *African Political Ethics and the Slave Trade: Central African Dimensions*, (unpublished manuscript on file with author, 2001) *available at* http://www.millersv.edu/~winthrop/Thornton.html (visited July 11, 2001).

[13] John Thornton, Africa and Africans, at 71. John Thornton's main point was that no European nation could control the terms of trade at the expense of Africans, the examination of the tax revenue to Europe being peripheral to his inquiry.

[14] John Thornton, Africa and Africans, at xiii (Map 4), 130–41; Walvin, Black Ivory, at 6–10. The legacy of slavery in Central and South America is largely unknown to the general American audience.

slaves over a thirty year period, with profits to be split between the Royal African Company and the Crowns of England and Spain.[15]

Once African[16] slaves began to arrive in Virginia and Maryland, they joined indentured Britons in the cultivation of tobacco.[17] In the 1660s, duties on the export of tobacco amounted to 25% of worldwide English customs revenues and 5% of the Crown's entire income. Colonial tobacco duties raised £100,000 per year by the mid 1670s for Charles II. By 1699, the tobacco duties reached £400,000 annually.[18] Maryland laid an import duty on white servants and Negro slaves as early as 1695.[19] The duty on Negro slaves was four times greater than the duty on white servants.

As the Atlantic trade in slaves and slave commodities boomed, the sponsoring governments and their colonies reaped huge financial rewards.

B. Slave Taxes in the Colonial States

In 1775, of the 331,000 blacks living in British North America, 310,000 lived in the Carolinas, Georgia, Virginia and Maryland.[20] Not only did slaves produces taxes for the states, but in an era of monetary shortage, slaves provided an important form of taxable wealth that could be bought and sold.[21] Slaves also produced the crops – first tobacco and then cotton – which generated colonial wealth.

1. South Carolina

Reliance on slave taxes was a consistent feature of South Carolina's government finance. In the 1730s, the slave duty was £50[22] per imported slave, sufficient to fund two-thirds of the needs of government.[23] In the years

[15] W.E.B. Du Bois, The Suppression of the African Slave-Trade To the United States of America, 1638–1870 3 (Philip S. Foner ed., Dover Publications 1970) (1896).
[16] This discussion does not include the enslavement of indigenous people in the Americas, which was substantial, particularly in Central and South America.
[17] In 1660, the bulk of the tobacco labor force was free or indentured rather than slave, but massive slave importations began in earnest with the tobacco boom, reaching 40,000 resident slaves by 1670 with an additional 100,000 imported into the region from 1690 to 1770. In addition, North American slaves were able to support internal population growth. Walvin, Black Ivory, at 8–9.
[18] Tax Analysts, Inc., Tax History Project, 1660–1713 *available at* http://www.tax.org/museum/1660-1712.htm.
[19] An Act for the laying on Imposition upon Negroes Slaves & White servants Imported into this Province, 38 Md. Arch. 51 (May 1695), in Bernard Chrstian Steiner, ed., Proceedings and Acts of the General Assembly of Maryland, 1694–1729.
[20] Walvin, Black Ivory, at 9.
[21] George Ruble Woolfolk, *Taxes and Slavery in the Ante Bellum South*, 26 J. Southern Hist. 180, 182 (1960).
[22] South Carolina colonial currency.
[23] Margaret G. Myers, A Financial History of the United States 19 (1970) (data from 1731).

prior to the Revolutionary War, the slave duty still raised from a quarter to one half of the financial needs of the government.[24]

Fear of slave revolts motivated the legislature to occasionally impose prohibitively high tariffs, which affected slave duty revenue. South Carolina alternatively raised and lowered the tariff many times, sometimes offering lower duties for African slaves, who presumably knew nothing of the slave insurrections in the West Indies.[25] From 1695 to 1705, six colonies established control policies favoring newly captured Africans over revolt-prone West Indian slaves, a pattern which was repeated throughout the slave period.[26]

In addition to slave import taxes, South Carolina raised funds through a property tax on land and a poll tax on slaves in 1777.[27] After the Constitution banned export taxes, South Carolina emphasized property taxes on slaves. In the decades prior to the Civil War, direct slave taxes raised approximately 60% of the revenue of South Carolina's state, county and local governments.[28]

2. *Georgia*

In the Colonial era, Georgia's financial needs were quite modest, averaging only £2,215 per year from 1763 to 1773. The tax on each slave was equalized to the tax borne by 100 acres of land.[29] In 1849, 49% of Georgia's state property tax came from the slave property tax. Eight years later, it was still 42.3% of the total.[30] This allocation of the taxing burden generally reflected the fact that slaves were nearly half of the wealth of the state.[31]

In addition to the property tax, the state imposed a poll tax of $0.39 per slave.[32] Poll taxes in this period had little to do with voting, but rather operated in the case of slaves as a property tax paid by their owners.[33]

[24] Becker, Revolution, at 16–18 (citing data from September 1763 to December 1769).
[25] Becker, Revolution, at 80, 208–09; Du Bois, Suppression, at 9–11; Darnold D. Wax, *Preferences for Slaves in Colonial America*, 58 J. Negro Hist. 371–401 (1973).
[26] Wax, Preferences, at 371–401.
[27] Becker, Revolution, at 207.
[28] J. Mills Thornton, III, *Fiscal Policy and the Failure of Radical Reconstruction in the Lower South*, *in* Region, Race, and Reconstruction: Essays in Honor of C. Vann Woodward 351 (J. Morgan Kousser & James M. McPherson eds., 1982); Peter Wallenstein, From Slave South to New South: Public Policy in Nineteenth-Century Georgia 41 (1987). In 1850, the tax was $0.56 per slave and accounted for 63.1% of South Carolina's revenue. *Id.*
[29] Becker, Revolution, at 245, Appendix Table 19.
[30] Wallenstein, From Slave South to New South, at 40, 57.
[31] Wallenstein, From Slave South to New South, 14 (1860 data).
[32] Wallenstein, From Slave South to New South, at 41.
[33] Becker, Revolution, at 77.

3. *Virginia*

The notable feature of Virginia's colonial finance was the success of the tobacco export tax, reaping £7,000 in 1770.[34] Since the late seventeenth century, slaves were producing the bulk of Virginia's tobacco. The Revolutionary War disrupted tobacco commerce, leaving Virginia scrambling for revenue to meet war requirements. Virginia responded with taxes on land, silver and gold plate, slaves, horses, and mules.[35]

In the midst of a very difficult period for the Continental Army, Virginia devised a plan to recruit additional soldiers by promising a personal slave as a bounty for enlistment. Virginia planned to obtain these slaves by taking 5% of the slaves from any Virginian who owned more than 20 slaves. Large slaveholders opposed the plan, and the slave bounty did not pass.[36]

4. *Maryland*

Tobacco also figured prominently in Maryland's tax system. In 1775, Virginia and Maryland exported 220 million pounds of tobacco.[37] Maryland imposed a poll tax of 30 pounds of tobacco for the benefit of Anglican clergy, raising £8,000 sterling a year in 1766. Maryland also imposed an ad valorem tax on slaves, servants, and merchants' stock-in-trade.[38]

5. *North Carolina*

In North Carolina in 1763, 75% of the colony's revenue was derived from a poll tax on every white male 16 or older and on all blacks, slave or free, male or female, over the age of 12. Taxes on property (including slaves) continued during the Revolutionary War, when an *ad valorem* tax was imposed in 1777.[39]

6. *Other Southern States and Southern Cities and Counties*

In Florida, Louisiana and Mississippi, although the slave populations were smaller, the story was similar: direct slave taxes raised from 30 to 40% of the revenue.[40] Alabama levied a 0.2% property tax on the value of slaves, land and other property, with slave values ranging from $100 to $550 each.

[34] Becker, Revolution, at 78.
[35] Becker, Revolution, at 196–98.
[36] Becker, Revolution, at 199.
[37] Walvin, Black Ivory, at 9.
[38] Becker, Revolution, at 79, 91.
[39] Robert A. Becker, Revolution, Reform, and the Politics of American Taxation, 1763–1783 243–44, Appendix Tables 77, 192 (1980).
[40] J. Mills Thornton, *Fiscal Policy*, at 351.

At those rates, slightly less than half of Alabama's state property tax came from slaves, while less than a quarter was on agricultural land.[41]

Most state governments also allowed the local units of government to tax slaves as well, often at a percentage of the state rates. For example, the City of Charleston in 1838 received over 22% of its total revenue from direct slave taxes.[42]

7. *New York*

As early as 1709, New York taxed both slaves and chimneys under the same law.[43] New York placed duties in 1734 on imported cider, beef and pork and ordered a census and poll tax of one shilling on slaves aged fourteen to fifty. If the owner did not pay the slave tax, the collector could levy and destrain the slave, and if not redeemed within four days, sell the slave at a public auction to the highest bidder to pay the tax. The tax was to be used to build fortifications to defend the colony.[44] New York collected impost taxes averaging about £5,000 a year in the period 1760 - 1774 from duties upon imported rum and other liquors, wine, cocoa, slaves, and dry goods from Europe.[45]

8. *New Jersey*

Slavery existed in New Jersey from the beginning and continued in limited form until the ratification of the Thirteenth Amendment, making New Jersey the last Northern state to abolish slavery.[46] New Jersey taxed slave imports, beginning in 1714.[47]

9. *Other Northern States*

In 1796, slaves were taxed in New Jersey, Pennsylvania, Maryland, Virginia, Kentucky, North Carolina, South Carolina and Georgia, but not in Vermont, New Hampshire, Massachusetts, Rhode Island, Connecticut, New York or Delaware.[48] Pennsylvania and Massachusetts taxed imported slaves prior to

[41] Wallenstein, From Slave South to New South, at 41, n. 12.
[42] Woolfolk, Taxes and Slavery, at 183–84 ($27,046.50 out of a total of $121,195.50 in 1838).
[43] Myers, Financial History, at 17.
[44] An Act to Lay a Duty on the Goods, & a Tax on the Slaves therein Mentioned During the time & for the Uses Mentioned in the Same, The Colonial Laws of New York from the Year 1664 to the Revolution, Vol. 2, Ch. 624, pp. 876–884 (Nov. 28, 1734).
[45] Becker, Revolution, at 47.
[46] Gary K. Wolinetz, *New Jersey Slavery and the Law*, 50 Rutgers L. Rev. 2227, 2228, 2238, 2256–57 (1998).
[47] Wolinetz, New Jersey Slavery, at 2235.
[48] Richard T. Ely, Taxation in American States and Cities 118 (1888).

the Constitution,[49] with a view to discourage the traffic.[50] Rhode Island's slave import duty was used to pave the streets of Newport, to build bridges, and other municipal improvements.[51] One early Massachusetts poll tax repaired 'their majesties' castle, upon Castle Island, near Boston.'[52] While Massachusetts, Rhode Island, and Connecticut disfavored slavery at home, their vessels plied the Atlantic slave trade for commercial gain.[53]

10. Other Governments

The American colonies were not unique in their reliance on Slave Taxes for government finance. The British West Indies colonies used slaves to produce sugar for export to Europe. High duties were placed on competing East Indian (non-slave) sugar, resulting in an artificial government subsidy of slave-produced sugar to the amount of £4 million per year in the 1820's.[54] The French and the Danish also operated sugar colonies with slave labor and tax incentives,[55] while the Spanish and Portuguese possessions in the Western Hemisphere were highly dependent upon slave labor. African governments also derived revenue from the slave trade.[56] The sultan of Zanzibar levied a tax on each exported slave. This tax was such a significant portion of his revenue that Zanzibar resisted British efforts in the nineteenth century to abolish the slave trade. Zanzibar eventually signed an abolition treaty in 1873, but only after Britain agreed to pay Zanzibar £8,000 per year in compensation, a payment which continued until 1968.[57]

C. Slave Taxes and Racist Social Policy

1. Tax Preferences for Importation of 'Good' Slaves

In addition to raising revenue for the government, taxes on slaves served racist social purposes as well. Throughout the South, import duties were

[49] Davis Rich Dewey, Financial History of the United States 16 (2d edn., 1903).
[50] Du Bois, Suppression, at 20–24; Myers, Financial History, at 15, 18.
[51] Du Bois, Suppression, at 34, n. 4.
[52] *An Act for Granting unto Their Majesties a Tax of Twelvepence a Poll, and One Penny on the Pound for Estates 1694–95*, Acts and Resolves, Public and Private, of the Province of Massachusetts Bay, Vol. 1, Chap. 2 (21 Vols. Boston, 1869–1922).
[53] Du Bois, Suppression, at 27–31.
[54] James Walvin, The Public Campaign in England Against Slavery, 1787–1834, in David Eltis and James Walvin, eds., The Abolition of the Atlantic Slave Trade, Origins and Effects in Europe, Africa, and the Americas 71–72 (1981).
[55] David Eltis, Economic Growth and the Ending of the Transatlantic Slave Trade 49 (1987).
[56] The price paid for slaves on the coast of Africa was a small percentage of the price for a health arrival on the auction block in Havana or Charleston; nevertheless, the African governments which controlled the slave trade were paid for delivering slaves. The enormous social cost to Africa and Africans of this trade is not belittled by this observation.
[57] Charles H. Fairbanks, Jr. with Eli Nathans, The British Campaign Against the Slave Trade, in Plattner, Marc F., ed., Human Rights in Our Time: Essays in Memory of Victor Baras 53–9, (1983).

modified to restrict the importation of troublesome slaves from Caribbean islands which had experienced slave revolts. Tax policy preferred slaves fresh from Africa.[58] In the Danish slave colonies, talk of abolition prompted fears as to whether the slave population could keep up with the death rate if importation became illegal. The 1792 Danish Royal Decree abolished the Danish slave trade and slave imports into the Danish West Indies, but delayed the legal effect until 1802 to allow for enough slaves to be imported in the ensuing decade to keep the sugar plantations staffed. Exports of slaves were forbidden, and tax incentives were granted to encourage the importation of female slaves, particularly female field hands, so that slave breeding would be more prolific.[59]

2. *Tax Discrimination against Free Blacks*

In the early eighteenth century, the taxation of free blacks differed little from whites and slaves. Immediately before the Revolution, the use of special taxes on free blacks for discriminatory purposes took root and grew.[60] In all the states of the Lower South save Louisiana, free blacks were subjected to a higher poll tax under a deliberate social policy to reduce the free black population.[61] In Georgia, much higher taxes were placed on free blacks in order to encourage them to leave the state.[62] Slaves were taxed at $0.39 each while free blacks were required to pay $5, a very significant sum in the 1850s.[63] Free blacks who failed to pay had their property seized and sold at auction; those with taxes remaining were themselves sold at auction into involuntary servitude to pay the tax.[64]

The poll tax was pressed into service to restrict voting in the 1890s and early 1900s, complimenting literacy tests and residency requirements.[65] Disenfranchisement was not focused solely on blacks: it was also an anti-Populist measure against poor white farmers as well.[66] The states with the

[58] Becker, Revolution, at 80, 208–09; Du Bois, Suppression, at 9–11; Wax, Preferences, at 371–401.
[59] Hans Christian Johansen, The Reality behind the Demographic Argument to Abolish the Danish Slave Trade, in David Eltis and James Walvin, eds., The Abolition of the Atlantic Slave Trade, Origins and Effects in Europe, Africa, and the Americas 221–24 (1981).
[60] Woolfolk, Taxes and Slavery, at 188, 190–91. Georgia lowered taxes on whites and slaves in 1763 and again in 1770 and 1773, but the poll tax on free blacks remained high, increasing to £1 in 1773, up 33% from 1768. Becker, Revolution, at 77–78.
[61] J. Mills Thornton, *Fiscal Policy*, at 353. Higher taxes would both encourage migration out of the state as well as hinder free black immigration.
[62] Wallenstein, From Slave South to New South, at 87.
[63] Wallenstein, From Slave South to New South, at 90. The $5 tax was the same amount required from white professionals, such as lawyers. *Id.,* at 41.
[64] Wallenstein, From Slave South to New South.
[65] Frederic D. Ogden, The Poll Tax in the South 281 (1958).
[66] Ogden, The Poll Tax, at 282.

most significant poll tax for disenfranchisement were Virginia, Mississippi and Alabama (in that order), followed by Arkansas and Texas.[67]

In addition to poll taxes to discriminate against free blacks, many Southern states and cities enacted occupational taxes on slaves and free blacks which favoured white labour in the skilled professions.[68]

3. *Class Conflict over Slave Taxes*

The level of taxes on slaves represented a political compromise within particular Southern states between rich planters and poor white farmers.[69] This tension was often expressed in debates over the assessed value for tax purposes of slaves and land.[70] In this manner, poor white farmers who were not slave owners themselves directly gained from slave taxes to the extent that the tax burden fell some place else. Every white person had a stake in the slave tax system.[71]

For example, the Tennessee Constitution of 1796 established that no slave could be taxed at a rate higher than two hundred acres, double the rate of a white man.[72] The level of slave taxes throughout the South allowed taxes on white men, land and other property to remain at quite low levels.[73] Benefits were not limited to the South; the federal direct taxes on slaves also directly reduced taxes on land, houses and other property throughout the country, including the North. Northern farmers and home owners received a financial benefit from direct federal slave taxes in 1798 to 1802 and again during the War of 1812.

[67] Ogden, The Poll Tax, at 284.
[68] Woolfolk, Taxes and Slavery, at 184–86.
[69] Planters held a disproportionate share of political power, and although they paid significant taxes on slaves, the tax was generally lower than the tax on land when one compares actual market values. The slave owner paid taxes, but not excessively so, compared to the wealth held by the plantation owners. Wallenstein, From Slave South to New South, at 41–42, n.12.
[70] Robin L. Einhorn, *Slavery and the Politics of Taxation in the Early United States*, 14 Studies in Am. Pol. Developments 156, 178–79 (2000) (Federal tariffs and direct taxes to 1800); J. Mills Thornton, Fiscal Policy, at 356–57 (Lower South); Donald C. Butts, *The 'Irrepressible Conflict': Slave Taxation and North Carolina's Gubernatorial Election of 1860*, 58 N. Car. Hist. R. 44–66 (1981) and Donald Cleveland Butts, *A Challenge to Planter Rule: The Controversy Over the Ad Valorem Taxation of Slaves in North Carolina: 1858-1862* (1978) (unpublished Ph.D. dissertion, Duke University) (North Carolina); Dall W. Forsythe, Taxation and Political Change in the Young Nation 1781–1833 (1977) (taxation and regime politics generally); and Woolfolk, Taxes and Slavery, at 197 (Georgia).
[71] Einhorn concludes that the unique features of the apportioned direct federal tax on slaves adopted in 1798 muted class conflict in the South, but exacerbated it in the North. Einhorn, Slavery and the Politics of Taxation, at 178–79.
[72] Tenn. Const. of 1796, Art. I, Sec. 26 ('All lands liable to taxation in this state, held by deed, grant or entry, shall be taxed equal and uniform, in such manner that no one hundred acres shall be taxed higher than another, except town lots, which shall not be taxed higher than two hundred acres of land each; no free man shall be taxed higher than one hundred acres, and no slave higher than two hundred acres, on each poll.'); Ely, Taxation in American States and Cities, at 117.
[73] J. Mills Thornton, *Fiscal Policy*, at 351.

4. *Black Land Ownership*

One effect of slavery and the prohibition on free black land ownership in many states[74] was that most blacks were locked out of the most significant American wealth-building opportunity of the eighteenth and nineteenth centuries: the availability of cheap public lands for sale in the United States. It was a historic opportunity cost.

For example, a major source of revenue in Georgia was the sale of lands 'ceded' by Native Americans to the State. These lands were sold to white citizens in lotteries (free blacks were excluded).[75] The lucky farmer selected in the lottery could purchase a parcel of 202.5 acres at an attractive price. From the early 1800's to 1832, Georgia collected $1.7 million dollars on these land sales. Given the small size of the state budget, $1.7 million was a huge sum: between the War of 1812 and the Civil War, taxes paid less than half of the state revenue of Georgia.[76] In his comprehensive study of public policy in nineteenth-century Georgia, Peter Wallenstein noted:

> No phenomenon better captures the fundamental race bias of public policy in Georgia than the most important undertaking of the state government during its first half-century under the U.S. Constitution: the transfer of land from Indians to whites, land that was in turn, much of it, worked by slaves.[77]

Slavery and discrimination prevented the vast majority of blacks from purchasing state and federal lands during the eighteenth and nineteenth centuries. Although Slave Taxes had contributed to the funding of the Louisiana Purchase,[78] slaves had no opportunity to settle a homestead themselves.

C. Federal Slave Taxes

> The blessings in which you, this day, rejoice are not enjoyed in common.
> The rich inheritance of justice, liberty, prosperity and independence
> bequeathed by your fathers, is shared by you, not by me.
> The sunlight that brought life and healing to you, has brought stripes and death to me.
> This Fourth [of] July is yours, not mine. You may rejoice, I must mourn.
> Frederick Douglass, 'What to the Slave is the Fourth of July?' July 5, 1852[79]

[74] Wolinetz, New Jersey Slavery, at 2234.
[75] Wallenstein, From Slave South to New South, at 89.
[76] Wallenstein, From Slave South to New South, at 10, 27, 40.
[77] Wallenstein, From Slave South to New South, at 95.
[78] W. Elliot Brownlee, Federal Taxation in America 16 (1996) ('Tariff revenues, in combination with the debt finance that the general [slave, houses and land] taxing power made possible, funded the Louisiana Purchase'). Note my use here of the broader term 'Slave Taxes,' as described above in n 3.
[79] Speech given by Frederick Douglass to the Rochester Ladies' Anti-Slavery Society, Rochester, New York, July 5, 1852. James M. Gregory, Frederick Douglas, the Orator 103–06 (1893).

1. *The Continental Congress*

The continued existence of the Continental Congress was fully dependent upon acceptance of slavery. Embracing slavery was the price of liberty from the British.

On July 30, 1776, Congress was discussing raising taxes to finance the Revolutionary War. The discussion had centered on using population as a method to apportion the tax burden amongst the states. A question arose whether to count slaves as people for tax purposes. James Wilson feared that not counting slaves would 'be the greatest Encouragement to continue Slave keeping.'[80] Thomas Lynch of South Carolina then delivered what came to be known as the Lynch Ultimatum: 'If it is debated, whether their Slaves are their Property, there is an End of the Confederation.'[81]

The Continental Congress did not have the power to tax directly, but instead assessed amounts against the various states, who then voluntarily paid requisitions out of their own funds.[82] Southern states were heavily dependent on direct slave taxes, and all of the states derived significant revenue from indirect slave taxes.[83] These funds were then passed on to the Continental Congress to fight the Revolutionary War. In 1783, for example, South Carolina levied a property tax *in specie* on slaves, other property and imported goods. South Carolina was to pay 52% of its budget to Congress that year to meet its requisition for Revolutionary War debts.[84] Collection was difficult in this post-war period, and many taxes were collected by execution and public auction.[85] If the Revolutionary War was 'the price of liberty,'[86] a significant portion of that price was paid with Slave Taxes, including slaves sold on the auction block.

2. *Slave Taxes under the Constitution*

> [T]he power to tax involves the power to destroy.
>
> Supreme Court Chief Justice John Marshall[87]

[80] John Adams, 'Notes of Debates on the Articles of Confederation.' July 30, 1776, in Diary and Autobiography of John Adams, ed. L.H. Butterfield, 4 fols (Cambridge, MA: Harvard University Press, 1961), 2:245–46 and Thomas Jefferson, 'Notes of Proceedings in the Continental Congress,' July 12, 1776, in The Papers of Thomas Jefferson, ed. Julian Boyd et al., 27 vols. (Princeton: Princeton University Press, 1950–1997), 1:322.
[81] John Adams, 'Notes of Debates on the Articles of Confederation.' July 30, 1776, in Diary and Autobiography of John Adams, ed. L.H. Butterfield, 4 fols (Cambridge, MA: Harvard University Press, 1961), 2:245–46.
[82] Brownlee, Federal Taxation in America, at 11; Roger H. Brown, Redeeming the Republic: Federalists, Taxation and the Origins of the Constitution 11–12 (1993); Forsythe, Taxation, at 14.
[83] *See* above nn. 20–47 and text accompanying.
[84] Brown, Redeeming the Republic, at 69–70. This amount declined sharply in 1784 and reached zero in 1785 as the debts were paid off.
[85] Brown, Redeeming the Republic, at 70.
[86] Attributed to James Madison.
[87] *McCulloch v Maryland*, 17 U.S. 316, 431 (1819) (Marshall, C.J.).

The present Constitution was not ratified until 1789, replacing the Articles of Confederation. One question faced by the drafters was whether slaves would count as persons for apportioning direct taxes among the states. Counting slaves would increase the direct taxes paid by the South.[88] Southerners, anticipating Marshall's dictum, worried about slavery being taxed to extinction,[89] but they wanted the additional Representatives in the House that would result from counting slaves as people. The eventual compromise counted slaves as 3/5ths of a person for both purposes.[90]

Since most federal taxes from 1789 to the Civil War were not direct taxes subject to apportionment, the Southern concession on taxes cost them little, while the South was guaranteed additional representation in Congress.

The Constitution grants the federal government exclusive control over import duties,[91] but the South won another protection against 'the power to destroy' in that the federal import duty on slaves could not exceed $10.00.[92] In the first Congress, Josiah Parker of Virginia introduced a motion to impose the $10 federal slave duty as a means to raise revenue. South Carolina and Georgia reacted strongly, as the burden of the tax would fall on slave importers in their states. The ensuing arguments threatened to derail the first U.S. revenue act, until it was referred to a committee chaired by Parker and never heard from again.[93] The US never imposed the $10 federal slave duty.

After the slave trade was abolished in 1808, the slave trade continued under lackluster enforcement. If a slave ship was captured, the ship was taken to the nearest port. If that port was in a slave state, the slaves could then be sold on the auction block rather than freed, with the proceeds paid to the federal treasury.[94]

3. *Direct Federal Slave Taxes*

> [T]hese debates demonstrate the centrality of slavery to the design of a national tax system.

[88] Robin Einhorn points out that while counting slaves would increase total Southern taxes, it also increased class conflict in the North while assuaging it in the South. Einhorn, Slavery and the Politics of Taxation, at 178.
[89] Einhorn, Slavery and the Politics of Taxation, at 168.
[90] U.S. Const., Art. I, Sec. 2, cl. 3.
[91] U.S. Const., Art. I, Sec. 8, cl. 1 and Art. I, Sec. 10, cl. 2.
[92] U.S. Const., Art. I, Sec. 9, cl. 1. This provision also delayed the abolition of the slave trade until at least 1808. Congress passed the law abolishing the slave trade into the U.S. on March 2, 1807, effective January 1, 1808.
[93] Annals of Congress, 1st. Cong., 1st sess, 349–56; 1st Cong. 2nd sess., 1223–33, 1239–47, 1464–66, 1500–14, 1516–25.
[94] An Act to Prohibit the Importation of Slaves into any Port or Place Within the Jurisdiction of the United States, From and After the First Day of January, in the Year of our Lord One Thousand Eight Hundred and Eight, U.S. Stat. at Large, Sec. 2 (March 2, 1807); Du Bois, Suppression, at 117–18 (description of a 1818 capture near Mobile, Alabama).

> From the 1776 attempt to draft Articles of Confederation to the end of the Federalist era, slavery intruded into every effort to create a tax system at the national level.
>
> Robin L. Einhorn, University of California, Berkeley[95]

After the adoption of the Constitution, Congress on two occasions imposed a direct federal tax on slaves. In 1798, Congress was preparing for a potential naval war with France in the wake of the 'XYZ Affair.'[96] Since customs duties were not raising enough funds to support military preparedness, Congress passed a direct tax on land, houses and slaves.[97] The Act of July 14, 1798 imposed a federal tax on slaves between the ages of 12 and 50 at $0.50 each.

In the debate, New Englanders opposed the slave tax, while Southerners insisted upon it because '[a]n apportioned tax on land and slaves would mute class conflict in the South but exacerbate class conflict in the North. This could only help Republicans and hurt Federalists.'[98] The compromise was to add 'dwelling houses' to the formula. In the final vote, the slave tax was supported by the Congressional delegations from Vermont, Delaware, New York, Pennsylvania, Kentucky, Maryland, North Carolina, Tennessee, Virginia, Georgia and South Carolina. It passed 67 to 23, gathering a majority of both Federalists and Republicans.[99]

This law required the first national tax return, listing 'in alphabetical order, the names of all persons owning, possessing, or having the care of any slaves, with the number of slaves, as aforesaid, owned by, or under the care of each person: And the forms of the said lists shall be devised and prescribed by the department of the treasury.'[100] The direct tax on houses, land and slaves was expected to raise $2,000,000, which would have been about 26% of the federal governments total expenditures in 1798 and about 18.5% of federal expenditures in 1800.[101] About 11% of the direct tax was expected to come from the tax on slaves.[102] While collections proved harder than assessment, direct slave taxes remained a small but significant part of the federal budget from 1798 until 1802 and beyond. Within three years, four fifths of the tax had been collected.[103]

[95] Einhorn, Slavery and the Politics of Taxation, at 182.
[96] Forsythe, Taxation, at 51–2.
[97] 1 U.S. Stat. at Large, (1798) 597–98.
[98] Einhorn, Slavery and the Politics of Taxation, at 178.
[99] Annals of Congress, 4th Cong., 2nd Sess., (Jan. 20, 1797); Einhorn, Slavery and the Politics of Taxation, at 180.
[100] 1 U.S. Stat. at Large, Sec. 16 (1798) 597–98.
[101] Forsythe, Taxation, at 52; Dewey, above note, at 109. Federal expenditures were modest in the period to 1797, used mainly to repay Revolutionary War debt, including the debts assumed from the states. 1796 $5,800,000; and 1797 $6,000,000. As tensions heated up with France, federal military spending increased: 1798 $7,600,000; 1799 $9,300,000; 1800 $10,800,000. Sidney Ratner, Taxation and Democracy in America 29 (1942, rep. 1967).
[102] Dewey, Financial History, at 109.
[103] Ratner, Taxation and Democracy, at 30.

In the election of 1800, Thomas Jefferson unseated John Adams as President, and Congress repealed the measure early in Jefferson's first term, on April 6, 1802.[104] Despite repeal, collections from the tax continued to come in for a number of years and helped to shore up the financial health of the American government while Jefferson negotiated the Louisiana Purchase. Gallatin financed the Louisiana Purchase in 1803 through $2,000,000 in cash surplus, $11,250,000 in new 6% stock redeemable after 15 years, and $1,750,000 in temporary borrowing.[105] U.S. customs revenue blossomed during the Napoleonic Wars, but the revenue from the direct federal tax was still a significant factor in U.S. federal finance during the purchased of the Louisiana Territory.[106]

In anticipation of the War of 1812, Secretary of the Treasury Gallatin proposed re-enacting various versions of the direct tax in order to support the war effort. On July 22, and August 2, 1813, with the war already underway, Congress passed a $3,000,000 direct tax, again on houses, land and slaves, with some modifications to improve collections.[107] One modification was the abandonment of the per head slave tax and the progressive house tax in favor of an ad valorem approach for both.[108] The annual revenue amount was doubled to $6,000,000 in the Act of January 9, 1815,[109] and an additional $3,000,000 in the Act of March 5, 1816.[110] The direct tax collected by December 1817 totaled $10,469,992[111] and financed forty percent of the War of 1812.[112] Although the War of 1812 soon ended, the taxes remained for a while to pay down the war debt. The direct tax on land, houses and slaves was repealed in the Act of December 23, 1817,[113] but collections continued in arrears until 1848.[114]

Congress attempted to impose a direct tax to finance the Mexican War, but Congress could not agree on the proper level of slave taxes.[115]

D. Indirect Slave Taxes

This essay up to this point has focused on direct slave taxes such as property and poll taxes. These taxes provided significant governmental revenue,

[104] The tax on slavery was not controversial. Public opposition centered on the Federalist use of any internal taxes at all. Forsythe, Taxation, at 54–57.
[105] Dewey, Financial History, at 121.
[106] The Napoleonic Wars produced customs revenues for the United States which far exceeded expectations, but the surge in revenue was only temporary. Forsythe, Taxation, at 57; Dewey, Financial History, at 121.
[107] Statutes at large, 3 (1813), 26, 53–71; Forsythe, Taxation, at 58–9.
[108] Einhorn, Slavery and the Politics of Taxation, at 183.
[109] Statutes at Large, 3 (1815), 164–80; Dewey, Financial History, at 139.
[110] Statutes at Large; Ratner, Taxation and Democracy, at 34.
[111] Dewey, Financial History, at 140.
[112] Brownlee, Federal Taxation in America, at 21; *see also* Dewey, Financial History, at 140.
[113] Statutes at Large, 3 (1817), 401–3; Dewey, Financial History, at 141.
[114] Einhorn, Slavery and the Politics of Taxation, at 160.
[115] House Journal, 30th Cong. 1st Sess. 347–48; Ratner, Taxation and Democracy, at 43–44.

but in most states they comprised a minority of the taxes collected. Direct slave taxes are not the full measure of the impact of slavery on governmental revenue, however. Without slavery, much of the other wealth of the states would not have been available for the coffers of government. Indirect slave taxes played a major economic role in government finance.

1. *Slave Improvements*

Property taxes were levied throughout North America on land, houses, capital, luxuries and other personal property in addition to slaves. Much of this property was either constructed by slaves or slave profits, or had its value enhanced by slaves. Slave owners benefited; as did the governments which taxed property.

Slaves and slavery were crucial to public revenue. Their labor gave value to the land, as public domain was converted to private farms and public funds. Moreover, taxes on slaves constituted nearly half of all the tax revenue of antebellum Georgia's state and local governments, and much of the rest of tax revenue came from land recently acquired from Indians.[116]

For plantation owners, the houses had been built with slave labor, or from the profits of slave labor. Plantation land itself was valuable only when worked by slaves, generally in the production of cotton, tobacco or rice. Even the luxuries taxed by the Southern states – such as carriages – were either built by slave labor or purchased with income from slave labor. Once these indirect taxes are accounted for, slaves and slave labor supported the bulk of the revenue needs of Southern governments.

2. *Shipping and Commerce*

Shipping and financial interests benefited from the slave trade and slave commerce. Yankee and British ships carried many slaves across the Atlantic or participated financially in the voyage, contributing to the fortunes of Newport, Boston, Philadelphia, Liverpool and London. Most of the exports of slave commodities – cotton, tobacco and rice – were carried in American shipping. By the 1750's, 95% of the commerce between the West Indies and the colonies was carried by American ships. The American merchant fleet carried 75% of the manufactured goods imported from London and Bristol. The economic benefit from slave-related commerce was important to the governments of New England and the rest of the states. In 1787, Samuel Hopkins wrote:

> The inhabitants of Rhode Island, especially those of Newport, have had by far the greater share in this [slave] traffic, of all these United States. This trade

[116] Wallenstein, From Slave South to New South, at 96.

in human species has been the first wheel of commerce in Newport, on which every other movement in business has chiefly depended. That town has been built up, and flourished in times past, at the expense of the blood, the liberty, and happiness of the poor Africans; and the inhabitants have lived on this, and by it have gotten most of their wealth and riches.[117]

3. *Customs Duties and Imposts*

The primary export crops of the South were slave commodities – tobacco, rice and indigo – with cotton growing to pre-eminence after the development of the cotton gin near Savannah, Georgia in 1793.[118] Slave commodities were the key exports from North America in the decades prior to the Civil War, earning the foreign exchange necessary to purchase European manufactured goods. In the fiscal year ending September 30, 1827, the United States exported $59,900,000 in goods to foreign countries. Of that amount, raw cotton accounted for $29,400,000 (49%); tobacco $6,600,000 (11%); and rice $2,300,000 (3.8%).[119] These three Southern crops represented nearly two-thirds of all US exports in that year.[120] By 1829, the slave states produced 29% of the world's supply of cotton, over 160 million pounds. By 1860, American slave cotton accounted for 66% of the world's supply, some 2.3 billion pounds. Exports of raw unmanufactured cotton alone were 40% of all US exports in 1816, rising to 57.5% of all US exports in 1860.[121]

While exports of slave commodities were crucial to the economy of the Republic, the benefit to the government was not as simple as a tax on the export of slave products. The South feared discriminatory tariffs and had demanded that the Constitution prohibit taxes or duties on exports.[122] But these crops were the major source of US exports and foreign exchange earnings, and the proceeds were used to purchase goods from abroad.

[117] Hopkins, Works II.615 (1854) *quoted in* De Bois, Suppression, at 34–35.
[118] Wallenstein, From Slave South to New South, at 8.
[119] Forsythe, Taxation, at 83.
[120] Forsythe, Taxation, at 83.
[121] Bailey, Ronald, The Slave(ry) Trade and the Development of Capitalism in the United States: The Textile Industry in New England, in Joseph E. Inikori and Stanley L. Engerman, eds, The Atlantic Slave Trade, Effects on Economies, Societies, and Peoples in Africa, the Americas, and Europe 205 (1992).
[122] U.S. Const., Art. I, Sec. 9, cl. 5. In Madison's notes to the Constitutional Convention debates on this provision, he wrote: 'General Pinkney … was alarmed at what was said yesterday, concerning the Negroes. He was now again alarmed at what had been thrown out concerning the taxing of exports. S. Carola. has in one year exported to the amount of £600,000 Sterling all which was the fruit of the labor of her blacks. Will she be represented in proportion to this amount? She will not. Neither ought she then to be subject to a tax on it. He hoped a clause would be inserted in the system restraining the Legislature from a taxing Exports.' [*1:592; Madison, 12 July*] Farrand, Max, ed. *The Records of the Federal Convention of 1787*. Rev. ed. 4 vols. New Haven and London: Yale University Press, 1937.

In the absence of exported slave cotton, the US could not have imported so freely from Europe. From 1789 to 1815, the federal government derived ninety percent of its revenues from duties on imported goods.[123] These duties were the primary source of federal revenue throughout the slavery period.

From the birth of the Republic to the eve of the Civil War, the majority of federal revenues were customs duties on goods imported with funds earned with the export of slave commodities. As General Pinkney said to the Constitutional Convention: '[South Carolina] has in one year exported to the amount of £600,000 Sterling all which was the fruit of the labor of her blacks.'[124] The fruit of slave labor purchased goods abroad, which, when imported into the US, funded the needs of the federal government until the Civil War.

III. CONCLUSION

Slave Taxes played a major role in American economic history, financing government during the colonial, Revolutionary and pre-Civil War periods. Slave Taxes were not a minor or incidental component, but a crucial source of revenue for improvements, wars, and government finance such as the Louisiana Purchase. Slave Taxes were both neutral or technocratic, and were both designed and applied to further racist social policies, including oppression of free blacks.

The stated goal of this essay was to begin the process of answering the first argument against black reparations: Slavery was a long time ago and everyone involved is now dead.[125] It can now be seen that some legal persons which benefited are very much alive, namely governments.[126]

More fundamentally, American democracy is generally unwilling to view the government as merely a legal person, but looks *behind* the government to the true source of legitimacy, the people.[127] Surely, governments were not the only beneficiaries of Slave Taxes. Free white citizens and immigrants used the improvements such as the Erie Canal; worked in factories using imported British machinery; drank tea with slave-produced sugar; dressed in slave-produced cotton; settled in lands taken from Britain and Native

[123] Brownlee, Federal Taxation in America, at 15–16. Total federal customs duties until 1815 were $223 million; all other federal revenues were $24 million, or about 10%. Myers, *supra* note, at 59. After the repeal of the second direct federal tax in 1817, almost all of the federal government's revenue came from duties.
[124] [*1:592; Madison, 12 July*] Farrand, Max, ed. *The Records of the Federal Convention of 1787*. Rev. edn. 4 vols. New Haven and London: Yale University Press, 1937.
[125] See Section I above.
[126] Similar research could be undertaken with regard to corporations.
[127] The dominant *mythos* of American democracy is the subject of hearty critique, beyond the scope of this essay.

Americans in wars or in the Louisiana Territory purchased from France; and otherwise enjoyed the benefits of the system. Slave Taxes benefited white American society in fundamental and enduring ways. If one claims the heritage of freedom, one might also accept responsibility for its history.

Part 4

Comparisons

13

The Chicken or the Egg?: A Historical Review of the Influence of Tax Administration on the Development of Income Tax Law in Australia

CYNTHIA COLEMAN AND MARGARET MCKERCHAR

ABSTRACT

THE CURRENT AUSTRALIAN tax climate is adversarial. Many taxpayers and practitioners believe that tax rates are too high, and the tax burden is not evenly spread. As a result, tax planning has become an important strategy for all parties, including the tax administration, which currently is attempting to take a pre-emptive role. Complex legislation can now be introduced in a remarkably short time, in stark contrast to earlier practice. For example, almost forty years ago, it took thirteen years to amend a section in the Income Tax Assessment Act (ITAA) after its weakness was exposed in a High Court of Australia decision.

Over time, the management style of the Australian Taxation Office (ATO) has fluctuated between relaxed and customer-orientated, to intimidatory and aggressive. The ATO has changed from being a paper-based organisation to being a leader in the use of technology for both administration and enforcement activities. Today, many of its processing activities lie in the hands of its customers, the taxpayers, with the shift towards self-assessment adding to the growing sense of the pervasiveness of tax matters in all aspects of everyday life.

The relationship between tax administration – its goals and management style – and tax legislation is explored in a historical context. What comes first and how has this changed over time? Has legislation and government policy dictated the style of tax administration, or alternatively, has the tax administration been the driver of tax reform in Australia?

INTRODUCTION

Juevnal, *Satire 3*, 60–63 (AD 100)
'… non possum ferre, Quirites,
Graecam Urbem. quamvis quota portio faecis Achaei?
iam pridem Syrus in Tiberim defluxit Orontes
et linguam et mores … vexit …'

'I cannot abide, Citizens,
a Greek city [a Greek Rome]; although what small section of our dregs are Greeks?
The Syrian Orontes has long since flowed into the Tiber,
and has carried with it its language and its morals … '

Juevnal, *Satire 3*, 235–238 (AD 100)
'… magnis opibus dormitur in Urbe.
inde caput morbi. raedarum transitus arto
vicorum in flexu et stantis convicia mandrae
eripient somnum Druso vitulisque marinis.'

'It costs a fortune to sleep in the City.
There lies the root of the disorder,
the coming and going of wagons
in the narrow winding streets, the abuse [of drovers] when the blocked cattle train
would deprive Drusus and sea-calves of sleep.'

'The city is overcrowded, noisy and polluted. There are too many immigrants from the East'. Sydney 2002? No, Rome 100 AD as described by the satirist Juvenal.

The words 'complexity, simplification, and problems with federal/state relations' are a common issue in virtually every report into the Australian Taxation System. Concepts such as equity and fairness are invariably mentioned. In Australia, the Income Tax Assessment Act is not used merely to raise revenue, but is linked to many social measures.[1] Tax policy is influenced by both social policy and political forces. At times, because the balance of power in the Upper House has been held by a minority party for a number of years, the government is forced to make compromises, for example, exempting food from the GST legislation. Lobby groups[2] also

[1] Examples include child support paid by non-custodial parents and the Higher Education Contribution Scheme.
[2] Examples include the Australian Council of Social Security and the Business Council of Australia.

play a role and can be very effective users of the media. The judiciary is a further stakeholder. The High Court in the 1970s refused to strike down many blatant tax avoidance schemes. Its interpretation of section 260 ITAA 1936, rendered it ineffective and therefore deprived the Australian Taxation Office of a compliance weapon. In general, the Australian public is interested in tax issues and they therefore often receive wide media coverage.

This paper will demonstrate that there has never been a structured process involving identification of tax policy issues and subsequent legislative reform in Australia. Instead, tax policy stems from a variety of sources: election proposals, taxpayer behaviour that causes the ATO to react and produce anti-avoidance legislation, pressure from special interest groups, parliament and the judiciary.

Australian taxpayers have mixed attitudes to paying tax: some are totally compliant, either voluntarily or because of lack of opportunity, others are aggressively non-compliant and in between the many who will participate in the cash economy when the opportunity arises.

INTRODUCTION OF INCOME TAX IN AUSTRALIA

Before Federation in 1902, the States were separate colonies which levied their own taxes. The principal sources of State revenue were from the sale of Crown land and from Tariffs and Excise.[3] The first colony to tax income was Tasmania with its Real and Personal Estate Duties Act 1880. The first comprehensive Income Tax was levied by South Australia under its Taxation Act 1884. This set a rate of 3d in the pound for personal exertion income, 6d in the pound for income from property (sometimes referred to as ‘unearned income’) and one halfpenny in the pound on the unimproved value of land. The economic slump in the 1890s was the catalyst for other Australian colonies to introduce their own Income Tax legislation. Income Tax was not introduced in New South Wales until 1895 and only then because the state was in deficit. An earlier attempt to introduce it in 1886 had failed because of strong opposition to the concept.[4]

When the Australian colonies were federated and became states in 1901, Federal Parliament was given a general power of taxation under Section 51(ii) of the Constitution. This general power was concurrent with

[3] Lehmann, G. and Coleman, C. *Taxation Law in Australia*. 4th edition. Sydney: LBC Information Services, 1996. Page 9.
[4] Woellner, R. Barkoczy, S. Murphy, S. and Evans, C. *Australian Taxation Law*. 12th edition. Sydney: CCH, 2002. Page 8.

the taxation powers of the states. Under Section 90 of the Constitution, the Commonwealth was given an exclusive power to impose customs and excise duties. The expectation was that customs and excise would provide adequate revenue for the Commonwealth so that the states would continue to levy income tax. The Federal Government did not introduce income tax until 1915. Because many Federal politicians had originally been ex-state Premiers or State politicians, they were hostile to the concept of federal income tax.

Federal Income tax was introduced to assist in funding World War I. Federal estate duties were also introduced at that time for a similar reason. The Income Tax Assessment Act (Cth) 1915 was modelled on state acts and intended to tax 'surplus wealth'. Income from personal exertion was taxed at progressive rates commencing at 1.2% and peaking at 25%. Income from property was taxed under a complicated formula with a maximum rate of 25%. Companies were taxed at a flat rate of 25%. The Act was sixty-five pages in length and consisted of 22 sections. When the Income Tax Assessment Act (Cth) 1936 was introduced it consisted of one slim volume. It contained the superseded Income Tax Assessment Act 1922, the new 1936 Act and the Explanatory Memorandum.

From 1915 until 1942 there was a two-tiered system for paying income tax. In 1942 because of the war, the Federal Parliament passed four Acts known as the Uniform Tax Scheme. Under this scheme:

1. A rate was set for federal income tax, which exceeded the combined federal and state rates.
2. Taxpayers paid federal income tax before state income tax.
3. The Commonwealth made grants to state governments to compensate them for their loss of income tax. These grants were conditional on the states not levying their own income tax.
4. State taxation officers transferred to the federal public service. The federal government took possession of state records and returns, office accommodation, furniture and equipment. The practical effect of this was that the states no longer imposed income tax and after the war this policy was continued for administrative convenience.

HISTORY OF TAX POLICY DEVELOPMENT IN AUSTRALIA

Australia has never had a structured process involving identifying tax policy issues and then writing legislation to give effect to that policy. There have been a number of Royal Commissions or government-sponsored enquiries into the tax system. Other contributors to the tax policy

debate are the Treasury, the private sector, the Australian Taxation Office, professional associations, lobby groups and the media, representing the views of the voters. The Australian Taxation Office (the ATO) is responsible for administering the tax laws. It is headed by the Commissioner of Taxation, who is appointed for seven years.

Tax policy historically has been developed in various government departments to give effect to political policy. Treasury has a tax policy division and the ATO also has a policy and legislation section, although on 1 August 2002 the people in that section were transferred to the Treasury. The Office of Parliamentary Counsel is responsible for drafting the legislation to give effect to the policy. For several years the ATO has operated using a system of consultative committees and meetings. The ATO is confident that this system works well and is committed to the concept of consultation. Private sector members of these committees have reported that it is often impossible to have difficult technical issues resolved, that these issues remain on the agenda for years and that pro-revenue technical amendments receive priority. The ATO is committed to the concept of consultation. These consultative meetings are rarely attended by members of the Treasury Department, or if Treasury does attend its role will be that of an observer. None of the many public inquiries into Australia's Tax System has focused on the role of the Office of Parliamentary Counsel, yet it is the department responsible for drafting clear legislation to give effect to the underlying policy.

ENQUIRIES INTO THE AUSTRALIAN TAX SYSTEM

There have been many enquiries into the Australian Tax System. The paper examines the terms of reference of each of them in chronological order and the consequent reforms. Most reports deal with standard themes of simplification, improved administrative practice, improved federal/state relations and methods of combating tax avoidance.

THE 1920s

With both the Commonwealth and the States levying income tax from 1915 until 1942, the parallel legislative structures led to inconsistencies, inequities and administrative problems. In 1920 the government appointed a Royal Commission[5] on Taxation chaired by W. Warren Kerr, CBE.

[5] Royal Commissions are regularly used in Australia. They have compulsive evidentiary powers and are used for a wide range of issues eg inquiry into police corruption, inquiry into the stevedoring industry etc.

THE WARREN COMMISSION[6]

The Warren Commission had the following terms of reference:

to enquire into and report upon the incidence of Commonwealth Taxation and into and upon any amendments which are necessary or desirable with a view to placing assessments of taxation upon a sound and equitable basis, having regard generally to the public interest, and particularly to-

1. *the equitable distributions of the burdens of taxation;*
2. *the harmonization of Commonwealth and State taxation;*
3. *the giving to primary producers of special consideration as regards the assessment of income tax, particularly in relation to loss relating from adverse weather conditions; and*
4. *the simplification of the duties of taxpayers in relation to returns and in relation to objections and appeals.*

Point 3 in the terms of reference deals with primary producers. Historically, primary producers have always been offered special tax concessions in recognition of their importance to the country. Over the years many special concessions have been introduced specifically for primary producers. In 1900 wool from Australia sold at one pound sterling for one pound of wool. The national attitude was 'Australia rides on the sheep's back'. Weather is always an issue for primary producers. Within three weeks of the breaking of a prolonged drought, there can be equally terrible flood conditions in the same region.

The Commission issued five reports, two of which dealt with Land Tax. These led to the Introduction of the Income Tax Assessment Act (Cth) 1922. Some of the recommendations included in the new act were:

1. Five year income averaging for primary producers, and later to other taxpayers except for companies.
2. Repeal of a tax on single people.
3. Increase in the deduction for a dependent child.

THE 1930s[7]

In Australia during the Depression the main focus for the government was trying to maintain revenue levels and deal with the unusual social and economic conditions.

[6] See Dirkis, M. 'Observations on the Development of Australia's Income Tax Policy and Income Tax Law,' *Bulletin for International Fiscal Documentation* 56 10, pp 522–533 (2002). This article is an excellent source of information regarding the development of tax policy in Australia.
[7] In addition to drawing on the Dirkis paper (at note 6), much of the historical material comes from the *ATO Story*, which is soon to be published on CD Rom.

Revenue was falling and there was conflict as both the states and the Commonwealth increased taxes on income and deceased estates. State governments justified the increase in taxes on the basis the new tax money would be used for unemployment relief. Commonwealth revenue from Customs and Exercise was falling and in 1930 the Commonwealth government introduced Sales Tax. The rate was 2.5%, but in 1931 it was increased to 6%. By the time it was repealed on 1 July 2000 and The Goods and Services Tax introduced the maximum rates was 33% on luxury items such as jewellery, electrical goods, furs, make-up. Because of the poor economic conditions in 1930, wholesalers initially had difficulty in passing on the tax to consumers. Ironically, when the Goods and Services Tax was first introduced many retailers similarly absorbed the cost and feared to pass it on to consumers. Before World War II income tax was about a quarter of revenue raised by the Commonwealth and a third of total taxation. The majority of the revenue came from indirect taxes such as sales tax and excise.

Conflict and duplication caused by having so many revenue raising bodies prompted the government to establish another Royal Commission headed by The Honourable David Ferguson a Judge of the Supreme Court of New South Wales.

THE FERGUSON COMMISSION

The brief of the Ferguson Royal Commission was to:

> *Inquire into and report upon the simplification and standardization of the taxation laws of the Commonwealth and of the States in so far as they relate to substantially the same subject matters of taxation, as for instance, income tax, land tax and death duties; and, in particular, to make recommendations for the purpose of obtaining uniformity in legislative provisions, including provisions relating to procedure and forms of returns.*

The Commission issued four reports, the last one dealing with death duties. The first three reports contained recommendations which were incorporated into amendments to the existing Tax Act and subsequently into ITAA 1936. Greater uniformity was achieved between Commonwealth and State Acts, there were amendments to the treatment of dividends and statutory exemptions on property and personal exertion income were changed so they applied to the same amount.

THE 1940s

During World War II the government had transferred income taxing powers from the states to the Federal Government and after the war this power remained with the Federal Government.

Patrick McGovern became Commissioner in 1946. The first problem he faced was how to meld the separate state offices into a cohesive national organisation. Each office tended to have its own practices and management styles. Australian states have always competed with each other rather than operated as a cohesive political unit. For example, at the time of Federation there were different rail gauge widths in each state so it was not possible to travel from Sydney to Perth without changing trains.

Australia's longest serving Prime Minister, Robert Menzies, was elected to power in 1949. The new government noted that 'the laws ... relating to income tax and social services contribution, have been permitted to fall into a serious state of complexity. The two factors that contributed most forcefully to this state of complexity are the separate levying of social services contribution and income tax and the system whereby the concessions for dependants, medical expenses and life assurances etc. are allowed by way of rebates instead of deductions from income.'

As a result, in 1950 the Government constituted the Commonwealth Committee on Taxation under the Chairmanship of the Honourable E. S. Spooner (Chartered Accountant).

THE 1950s

The country accepted many post WWII immigrants mainly from Italy and Greece. Hungarians arrived after the 1956 Hungarian uprising. Many married women left the workforce and returned to domestic duties (as described on official forms) and raised a family. Most people aspired to buy their own home. Inflation was low so paying off a mortgage was relatively manageable. There were some income tax rate changes in 1955 but no new taxes were introduced. Tax policy was not on the agenda. Any tax changes came about through election promises. Amendments were numerous but the main challenge faced by the ATO 'apart from the civilized tax planning engaged in by the wealthier taxpayers' was processing the increasing volume of paperwork and improving work procedures.

THE SPOONER COMMITTEE

The terms of reference of the Spooner Committee included:

> *the Committee will recommend any changes in law or procedure which it considers necessary to achieve the following objects:-*
>
> 1. *making the laws as simple and intelligible to the taxpayer as the nature of the legislation permits;*
> 2. *simplifying the duties of taxpayers under those laws, especially in the preparation of returns*

3. *removing anomalies in those laws; and providing an adequate and equitable basis of taxation.*

The ITAA 1936 was amended in 1950 to give effect to several of the recommendations:

1. The two separate levies on income tax and the social services contribution were combined into a single levy on taxable income.
2. Stepped rates of tax and contributions were added to the act.
3. Concessions for dependants, medical expenses and superannuation became deductible instead of being either rebates or a taxed concessional rate in order to fund the social services contribution.

These amendments meant that many families received a lump sum tax refund annually. It was often used towards some special family expenditure such as a holiday. The deductions system remained in the Act until 1977 when it was replaced by a general rebate. This meant the end of a large annual refund for most taxpayers. Many ordinary families at that time started to use a tax agent in order to maximize their refund.

The Menzies government introduced many other changes throughout the fifties. These included:

1. Method to value natural increase of livestock.
2. Primary producers could elect to withdraw from income averaging.
3. Averaging for primary producers when insurance was received from loss of livestock because of flood, fire or disasters.
4. Widening of the definition of primary production to include fishing and pearling operations.
5. Exemption from tax of scholarships and educational allowances.
6. Deductibility of educational expenses of children under 21 and engaged in full time education.
7. Age allowance provisions exempting retired people from income tax.
8. Averaging of abnormal income of artists, authors, composers and inventors.
9. 1959 dividend withholding tax – flat rate at source from dividends paid to overseas shareholders.

The Hulme Committee in 1955 investigated depreciation rates.

TAX ADMINISTRATION IN THE 1950s

The relationship between the ATO, taxpayers and tax practitioners in the fifties and sixties was professional and low key. As demonstrated by the

examples above tax policy came from the Government, often to prevent revenue leakage or to impose a little more equity in the system. It was the Government that appointed specialists to inquire into the Tax System and the ATO concentrated on administering the law.

In 1951 the Federal Government insisted on staff cuts and this occurred when the workload of the ATO was increasing. Post war prosperity and immigration had led to increased numbers of taxpayers. The ATO was wholly paper based and it was very difficult to obtain adequate numbers of competent administrative staff. The solution of Patrick McGovern, the Commissioner, was to set up typing sections within reasonable distance of larger cities such as Wollongong and Melbourne, which suited many people who could not relocate to Sydney.

Increased tax rates during the war years had led to greater non-compliance. The ATO concentrated a lot of its resources on assessment to improve compliance, but supported this with an education program. Forms were re-designed; explanatory booklets and pamphlets were issued, ATO officers visited country centres to deliver lectures to interested groups and participate in radio and television interviews. Taxpayers were encouraged to interact with the ATO. This was done through correspondence, telephone enquiries and over the counter enquiries. The ATO trained its officers to deal with the public and try to minimise the day to day irritations which occur through human frailty, the avoidable delay, a casual approach or a lack of interest. The administration encouraged among the staff an attitude of helpfulness and co-operation. This information was contained in the Commissioner's Annual Report in 1959. Apart from the lack of computer technology, this report could easily have been dated 1989 or 1999. Just as taxpayers in all countries indulge in similar behaviour, the issues faced by the revenue authorities are alike.

During this period the Tax Act did not change much, tax practitioners devised some planning for selected, usually wealthy clients, and all stakeholders in the system enjoyed a civilized professional relationship.

THE LIGERTWOOD COMMITTEE

In 1959 the Commonwealth Committee on Taxation was appointed under Sir George Ligertwood specifically to advise on tax avoidance issues. It had a narrow frame of reference and its main terms were:

(a) *to examine and enquire into the existing laws of the Commonwealth relating to taxation of income, and the operation of those laws, for the purpose of ascertaining any anomalies, inconsistencies, unnecessary complexities, and other similar defects that exist in, or arise out of the operation of those laws, and to formulate proposals for remedying those anomalies, inconsistencies, complexities and other defects and for simplifying those laws;*

A lot of the report dealt with relatively minor issues involving deductibility. The Committee recommended deductibility of provisions for long service (never enacted – the position in Australia remains that payments made in relation to long service leave or annual leave are only deductible when actually paid). It recommended:

1. Deductibility of discharge of mortgage expenses (subsequently enacted);
2. Deductibility for embezzlement (also enacted);
3. Changes to the taxable income threshold, (enacted) and
4. A time limit in which the Commissioner had to determine an objection. (never enacted). There is now judicial authority that the decision should be made within a reasonable time.[8]

The report specifically mentioned the assistance provided by the two people who were Commissioners at the time the submissions were received – Patrick McGovern and Sir Edward Cain.

THE 1960S

In the 1960s capital became more mobile and high-income professionals or high net worth individuals began to avoid tax. Nevertheless far less taxpayers were involved than the number who participated in the widespread schemes in the 1980s and late 1990s, when mass-marketed schemes became popular. The Ligertwood Report had investigated specific instances of tax avoidance.

One of the tax avoidance strategies in the sixties involved private companies rearranging their structure so they technically became public companies under the Act. This meant they avoided Division 7 undistributed profits tax which applied only to private companies. The Commissioner challenged the arrangement under s 260 of the ITAA 1936, the general anti-avoidance provision at the time. It stated:

> *every contract, agreement, or arrangement made or entered into, orally or in writing, whether before or after the commencement of this Act, shall so far as it has or purports to have the purpose or effect of in any way, directly or indirectly –*
>
> *(a) altering the incidence of any income tax;*
> *(b) relieving any person from liability to pay any income tax or make any return;*
> *(c) defeating, evading or avoiding any duty or liability imposed on any person by this Act; or*

[8] *Re FCT; Ex parte Australena Investments Pty Ltd* (1983) 15 ATR 162.

(d) preventing the operation of this Act in any respect, be absolutely void, as against the Commissioner, or in regard to any proceeding under this Act, but without prejudice to such validity as it may have in any other respect or for any other purpose.

The Australian judicial approach to tax avoidance followed that enunciated by Lord Tomlin in *Duke of Westminster v CIR* 19 TC 490 at 520 [1936] AC1 at 19–20. 'Every man is entitled to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be and that section 260 did not apply. Section 260 was repealed on 27 May 1981 and replaced by Part IV A.

In *Keighery v FCT* (1957) 100 CLR 66, the High Court established the choice principle, namely if a taxpayer arranged his affairs so as to qualify for specific treatment under the Act. In this case the taxpayer had technically qualified for public company status.

The Ligertwood Report had specifically referred to this deliberate restructuring of private companies to achieve public company status and recommended that a new definition of public company be inserted into the Act. This recommendation was adopted.

ALIENATION OF INCOME

Another issue dealt with in the Ligertwood Report was the alienation of income by high income earning professionals, sometimes through the use of interposed entities and service trusts. The report referred to the fact it was inequitable that such opportunities only benefited a small group of taxpayers. In *Sheperd v FCT* (1965) 113 CLR 385, Mr Sheperd made castors. He alienated the royalty income from the manufacture of the castors to six related parties for a period of three years. The High Court by majority upheld it as a valid equitable assignment. Section 102B was subsequently inserted into the ITAA 1936, with the effect that if the assignment was for less than seven years without the transfer of the underlying property, it was not effective for tax purposes.

TRANSFER PRICING AND TRADING STOCK

In 1964 the High Court decided *Cecil Bros Pty Ltd v FCT* (1964) 111 CLR 430. It involved a classic transfer pricing scenario, where a taxpayer purchased trading stock from an interposed entity. The High Court held that the arrangement was not caught by s 260 and that the taxpayer was entitled to deduct the full amount paid for the trading stock under s 51(1), the general deduction section.

FCT v Isherwood & Dreyfus Pty Ltd (1979) 9 ATR 47 involved an identical fact situation, except the interposed company was based in Hong Kong. The Full Federal Court followed the decision in *Cecil Bros*. Although this was an easy way to minimise tax, nothing had been done to prevent this situation from reoccurring until section 31C was inserted into ITAA 1936, with effect from 21 April 1977. The section applied where trading stock is purchased from non-arm's length parties at an inflated price. It gave the Commissioner a discretion to reduce the deduction to an arm's length value (currently s 70–20 ITAA 1997).

This tardiness to close an obvious loophole is to be contrasted with the 1980s when immediately upon discovery of a practice which involved loss of revenue, either the Commissioner or the Treasurer would issue a public announcement. The announcement described the arrangement, and stated that legislation to prevent it from being tax effective would be introduced to operate from the date of the announcement. Tax practitioners were expected to advise clients on the basis of an announcement when no legislation had appeared. In *FCT v Cooke & Sherden* (1978) 9 ATR 310, the Full Federal Court decided that free holiday trips given by a soft drink manufacturer to its selling agents were not convertible to cash and hence did not constitute income. The court had followed the English decision in *Tennant v Smith* [1892] AC 150.

In February 1985 the Commissioner issued an announcement that legislation would be enacted to ensure such arrangements did not escape the tax net. Because of the pressures of the September Reform of the Australian Tax System that year, s 21A, which dealt with non-cash business benefits, was not enacted until August 1988. Keeping abreast of pending announcements which affect advice given became such a nightmare for tax practitioners that the party which holds the balance of power in the Senate, the democrats announced it would not pass legislation unless legislation is introduced within six months of an announcement being issued.

THE DOWNING ENQUIRY

The Downing Enquiry in 1964 was an academic study commissioned by the Social Sciences Research Council. The Enquiry was particularly interested in the issue of equity. It noted increasing levels of tax avoidance nullified the effect of progressive rates and to prevent income splitting suggested that all family income other than wages and salaries be aggregated and given to the highest income earner. The Committee recommended better taxation of property income and capital gains and changes to the system of corporate tax. It criticised the classical system of company tax.

THE 1970s

In the early seventies, bracket creep and fiscal drag meant that more and more taxpayers were in the top tax bracket. In 1972, the Liberal Government under Prime Minister Sir William McMahon set up the Asprey Review Taxation Committee to undertake a comprehensive review of the Tax system. Immigration and changed social attitudes plus higher spending by all governments had increased the demand for revenue. The 1974 Whitlam Budget had put forward a simpler personal income tax scale, a surcharge on property income, a concessional deduction for home mortgage interest and Capital Gains Tax. Some industry specific concessions were abolished. The budget measures were never put into effect. The Whitlam Government had also tried to tax the value of employer provided company cars. When it was revealed that many unions provided cars to their officials, it was forced to back down.

TAX AVOIDANCE IN THE 1970s

The late 1960s and early 1970s saw the ATO forced into a reactive rather than a proactive role. The High Court followed the *Duke of Westminster* approach or the choice principle and upheld arrangements where taxpayers had structured their affairs so as to take advantage of a specific section in the Act. The main avoidance schemes involved trafficking in company losses to take advantage of the carry forward of loss provisions, trust stripping, and primary production averaging. In *Cridland v FCT* (1977) 8 ATR 69, a university student purchased a $1 unit in a primary production trust and qualified for the income averaging available to primary producers. The High Court acknowledged that this was not typical behaviour for a university student, but nevertheless said that he was entitled to the benefits offered by the Act. Although he was a passive beneficiary in the trust he was regarded as carrying on the business of primary production because this was the business of the trust. The High Court interpreted s 260 so narrowly as to render it ineffectual.

Tax planning and schemes became more widely marketed in the financial press. The ATO was aware of the problem but without the support of the judiciary there was little it could do to stop it. The only policy initiatives taken seem to have been specific and detailed anti-avoidance legislation. The annual reports of Sir Edward Cain as Commissioner reflect his knowledge of the problem, but do not refer to any policy initiatives to prevent the behaviour.

The Annual Report, 1971 stated:

> *An over-rigorous enforcement of a taxation system can imperil public respect for the system itself – it would require also that what might well be regarded*

> *as an unacceptably large proportion of public funds would have to be allocated for revenue collection purposes. On the other hand, a taxation system will enjoy community confidence only when it is possible to ensure a sufficiently high degree of compliance to satisfy fair minded taxpayers that they are not being called upon to bear an excessive share of the total burden.*

and the 1974 Annual Report asserted that:

> *No country can afford the resources needed to enforce an absolute level of compliance upon all of its citizens. There is necessarily a compromise between what might seem theoretically desirable and the resources that the community can spare for tax administration in the light of other priorities.*

THE ASPREY REPORT

The Asprey Committee, chaired by Justice Ken Asprey, was established by the Liberal McMahon government in 1972. It released its final report in 1975. It had been formed in response to widespread criticism of the tax system at the time. Because of increases in inflation and increases in overall government spending public attitudes to paying tax had declined markedly. The Committee was to have regard to 'the need to ensure a flow of revenue sufficient to meet the revenue requirements of the Commonwealth'. The Committee undertook the most comprehensive and cohesive review of the Australian tax system that the country had seen for decades. Another member of the Committee was Professor Ross Parsons of Sydney University, Australia's first full-time and leading tax academic.

The Committee made far reaching and extensive recommendations but none of these was acted upon. It recommended the need to have less reliance on income tax and to introduce a consumption tax following the European VAT model. The wholesale sales tax, which had been effectively avoided by taxpayers and which had a narrow base, was to be abolished. The Committee recommended partial imputation of company dividends, depreciation for income producing buildings, the introduction of a capital gains tax and a reformed system of estate and gift duties. Concessional rebates were to replace deductions (this was introduced by the Whitlam Government) and there were higher marginal rates on lower levels of income with a rebate for the poor. The lowest rate rose from 7% to 20%.

The Australian tax system limped along for a decade. The ATO was sidelined in the tax policy debate. The Government introduced specific anti-avoidance measures to overcome the effect of High Court decisions which had upheld contrived structures, for example *FCT v Westraders Pty Ltd* (1980) 11 ATR 24.

THE MATHEWS COMMITTEE

Under the chairmanship of Professor R Mathews, the committee was formed in 1983 to investigate the effects of inflation on the Australian economy and tax system. Inflation had shifted the tax burden to low income earners and large families. High marginal tax rates had been passed on to consumers in the form of higher prices. All taxpayers demanded more income to help them to combat the effects of inflation and the rising prices. The top marginal rate was 60 cents in the dollar and it cut in at $35 000.

Many taxpayers and tax commentators today would endorse Mathews' view that:

> *It would be difficult to improve on the present arrangements if we deliberately set out to design a tax system that required the poor to pay more taxes than many of the rich; if we deliberately wanted to discriminate against wage and salary earners and the proprietors of small businesses; if we deliberately decided to distort production decisions and consumer choice; if we deliberately sought to destroy incentives to save, invest, innovate, take risks, and undertake productive activity while simultaneously rewarding speculative activity and providing incentives as well as opportunities for avoiding and evading tax: and if we deliberately set out to make the tax system as complex, cumbersome, confusing and costly to administer and comply with as possible.*

The Fraser Government followed the main recommendation of the Committee and introduced indexation of marginal rates. It was fairly short lived. It deprived the Government of the ability to 'give' generous tax cuts in election times and it was costly for revenue. Bracket creep has always been a good source of revenue for governments. Commentators in Australia estimated in 2000 just before the Goods and Services Tax was introduced that the tax cuts which were given to ensure the measure was revenue neutral would be eroded within two to three years because of the effect of bracket creep.

BOTTOM OF THE HARBOUR

During the 1970s and 1980s, partly in response to inflation and higher rates of tax, tax avoidance became more widespread. Mass marketed schemes were advertised in the press, including the Sunday papers, promoters were profiled in the popular press as 'Robin Hoods' and headlines such as 'Total Tax Wipeout' were used to attract a wide range of investors. One of the most common schemes came to be known as 'Bottom of the Harbour'. The scheme consisted of deliberate stripping of a company's assets so that it

became unable to pay its taxes. The simplest example involved a company with no debts, an annual profit of $100 000, and a tax liability of $46 000. The company rate at the time was a flat 46%. In order to avoid paying taxes, the owner of the company sold it to a promoter, usually for the value of the profits minus a 10% commission. The owner received $90 000 for a company whose worth after tax had been paid was $54 000. The promoter kept the $10 000 and disposed of the company to new directors. These new directors were often vagrants picked up in parks. They were not interested in the company structure at all. All records were then disposed of by the promoters – the press called it 'sending them to the bottom of the harbour'.

The ATO seemed powerless to act because whenever it had challenged tax planning arrangements relying on section 260, it had usually lost in the High Court. The press and the public were openly applauding smart people who paid no tax. There was a popular saying to the effect that if you earned $200 000 you could guarantee paying no tax, but if you earned $100 000 you did not have enough income to ensure that you paid absolutely nothing.

What changed community attitudes and exposed the problem was an enquiry into the Federated Ship Painters and Dockers Union undertaken by Mr. Frank Costigan, QC.[9] When investigating criminal activities undertaken by members of the union, the Royal Commission exposed many tax avoidance schemes including the Bottom of the Harbour schemes. Participation in these schemes was widespread. Politicians, leading business people, and union officials had all participated. Roger Giles QC, the special prosecutor, estimated that billions of dollars of revenue had been lost. He commented that 'tax avoidance and evasion of this kind in such volume is extraordinary in absolute terms but almost incredible in relative terms having regard to the small Australian economy.'[10] This report changed public opinion towards tax avoidance. The percentage of the total tax paid by salary and wage earners was increasing and they felt that they had no opportunity to participate in such schemes and that avoidance by others meant that they shouldered an increasingly unfair share of the tax burden.

PREPAYMENTS

One common avoidance strategy was the use of prepayments by wealthy taxpayers to reduce their taxable income. For example, a high net worth barrister would invest in an agricultural scheme (typically something like a

[9] 'Royal Commission on the activities of the Federated Ship Painters and Dockers Union.' Discussed in Woellner et al. at note iv. Page 13.
[10] *Ibid.*

pine plantation which would not generate income for a long period of time), prepay by June 30 and claim as a deduction interest and management fees for a twenty-year period. The Courts upheld these schemes, generally holding that the taxpayer was in business. In *Walker v FCT* (1983) 14 ATR 75, a public servant had invested $4000 in one angora goat. His annual income was $27 000. The court held that the level of commitment to the enterprise (the goat and all offspring had died) meant that he was a primary producer and therefore entitled to claim his losses. The only response of the government and the ATO had been to introduce more anti-avoidance measures. Section 82KZL-KZM spaced deductibility of prepayments over the period of the loan.

THE DRAFT WHITE PAPER – REFORM OF THE AUSTRALIAN TAX SYSTEM (RATS)

The next comprehensive enquiry into Australia's tax system was undertaken by the Hawke Government in 1985, and the Tax Summit was held. Community input was taken into account. Professor Ross Parsons called the Australian tax system 'an institution in decay'. The public had lost confidence in the integrity of the tax system. The Draft White Paper was a Treasury based document produced to restore some integrity to the tax system. High marginal rates had led to large-scale avoidance. The Draft White Paper's main recommendations included:

1. Introduction of a comprehensive capital gains tax. The government decided to use grandfathering and Capital Gains Tax commenced on 20 September 1985. It still preserved the distinction between income and capital because CGT was paid on the post inflation gain. Problems arose because the legislation did not appear until June 1996 and clients had been advised by tax practitioners before any legislation was available.
2. Introduction of a full dividend imputation system. At the time of introduction, 1 July 1986, the maximum personal rate and the company rate were the same.
3. Introduction of Fringe Benefits Tax with effect from 1 July 1986.

ISSUES ARISING FROM RATS

Practitioners complained that because there had been no clear thinking on policy in relation to Capital Gains Tax, it took over ten years for technical legislative problems to be fixed. There were two anti-avoidance sections in the original legislation, 160ZZS and 160ZZT. Part IIIA, ITAA 1936,

imposing a tax on Capital Gains, consisted of 106 pages. Because of the grandfathering by the Government, many schemes consisted of the disposal of pre CGT assets. Many value shifting schemes became popular when taxpayers who controlled a company which had both pre and post CGT shares, reduced the value of the post 20 September 1985 shares in order to sell them tax free. After *FCT v Peabody* (1994) 181 CLR 359, Division 19B was introduced into the ITAA 1936. A new set of value shifting provisions is about to be introduced. It is a wholly anti avoidance measure. The Bill constitutes at present (2002) 136 pages.

FRINGE BENEFITS TAX

Commentators felt that there would have been no need for the introduction of Fringe Benefits Tax (FBT) if the government and the ATO had administered the ITAA 1936 more effectively. In 1985, the ITAA 1936 contained section 26(e) which taxed the value to the taxpayer of all benefits, allowances, and bonuses etc. given in an employment relationship or for services rendered. It had been put into the Act to overcome the effect of decisions such as *Tennant v Smith* [1892] AC 150. The courts and Boards of Review had interpreted the words 'value to the taxpayer' very narrowly. At one stage a company director who was provided with a fully maintained Mercedes car was taxed on the value of a weekly return train ticket to his local station. It was felt that a more simple solution would have been to for the ATO to make compulsory disclosure of the value of benefits provided by the employer on group certificates. Fringe Benefits Tax was imposed on employers for political reasons.

The FBT legislation put the expression 'unintended consequences' into Australian tax literature. As it was first drafted, section 54 operated to impose tax on sandwiches provided in a private home to the full time carer of a paraplegic. If a university professor had a meeting and provided sandwiches to fellow attendees who were not employed by the university, Fringe Benefits Tax was payable on the sandwiches the professor consumed. All universities is this position used to solemnly fill in paperwork for the ATO, stating that the professor concerned had brought his own sandwiches to the meeting. Fringe Benefits Tax was always very heavy on compliance costs. Its abolition was recommended by the Review of Business Tax, but the government was not prepared to forfeit the revenue.

Tax policy in relation to Fringe Benefits Tax consisted of an attempt by the government and the ATO to impose tax on progressively more benefits. The Fringe Benefits Tax Act in New Zealand, which had been introduced a little before the Australian FBT, consisted of 15 pages. In contrast, the Australian Act contained 56 pages of definitions alone. Increasingly more

items were brought into the tax net. Currently under the Act there are 47 different types of entertainment. At one stage the Act imposed tax on the half hour between planes spent by company executives in dedicated airport lounges such as the Qantas club because membership was paid for by the employer.

ATO POLICY INITIATIVES IN THE 1980s

A policy initiative instituted by the ATO in 1986 was the introduction of self assessment. Before 1986, taxpayers lodged annual returns which were checked carefully by assessors in the ATO. A notice of assessment was then prepared and dispatched to the taxpayer. A review of this procedure that the ATO carried out revealed that:[11]

1. It was not cost effective;
2. The method of assessment did not have a deterrent effect in achieving compliance with the tax laws;
3. There was little job satisfaction for existing staff; and
4. The method of assessment did not cope adequately with expensive and protracted disputes.

Substantiation provisions were also introduced in order to encourage taxpayer compliance. These were so strict on record keeping requirements that in once case a taxpayer who had paid by cheque to attend a work related conference, did not receive his claimed deduction because he lacked a paper based receipt.

In conjunction with the self-assessment regime, penalty provisions were altered and a new rulings system was introduced. In Australia the Commissioner has the power to issue Public Rulings, binding favourable Private Rulings (taxpayer-specific, transaction-specific, in relation to an actual issue), Product Rulings (setting out the ATO position with regard to deductibility of expenditure for investors in products, e.g. agricultural products like pine plantations – the ATO does not look at the commercial viability of the arrangement), and Class Rulings (for a particular class of taxpayer, e.g. employees who are eligible to participate in an Employee Share Acquisition Scheme). Recently the ATO has followed the Canadian model and publishes sanitized versions of Private Rulings. This is not meant to be a comprehensive or up to date resource for practitioners.

The ATO has always been at the forefront in adopting technology. It pioneered electronic lodgment of tax returns in 1988.

[11] Boucher, T. 'Self Assessment of Income Tax.' *Australian Tax Forum*. Vol 3 No 1, 1986, pp.44–53.

COMPLEXITY[12]

Tax policy began to consist of increasingly detailed anti-avoidance measures which added further complexity to the Australian tax system. In 1989 the ATO seconded a marketing specialist from the private sector to assist it in achieving better relations with taxpayers. The ATO slogan 'Taxes, building a better Australia' has never penetrated the local psyche. By contrast, the popular advertisement for Tooheys beer, in which sporting heroes proclaimed in response to the question, 'What do you feel like?', 'I feel like a Tooheys (or two) was known to everyone!' Aghast educators of primary aged children wrote to the press complaining that in creative writing classes, children as young as eight were finishing the sentence 'I feel like' with the punch line of the Tooheys advertisement.

ATO officers were trained to be customer oriented and to take pride in their job. They were issued with fridge magnets printed with 'Proud to be a tax officer…collecting the revenue'. Tax agents reported improved relationships with the ATO, which instituted a Dedicated Agents Program. A specific ATO officer became a liaison point for an agent and would try to answer any technical queries which the agent raised.

TAX POLICY IN THE 1990s

There was relatively little tax avoidance in the early 1990s. In 1993, John Hewson as the conservative leader in Opposition offered a wide ranging package of tax reforms to the electorate. The package was called 'Fightback.' Many state taxes such as Stamp Duty and Payroll Tax were to be abolished. Instead, Income Tax was to be restructured and a comprehensive VAT (the terminology used in Australia, New Zealand and Canada is Goods and Services Tax but it is identical to the European multi-stage VAT) at 15% was to be introduced. The Australian electorate has always been nervous of a GST.

The Labour party under Paul Keating sabotaged the Fightback package brilliantly. It used the slogan 'if you don't understand it, don't vote for it' and quietly omitted the fact that the same slogan could apply to many of the existing tax laws. When challenged on a television news program, John Hewson could not explain how the GST would affect the price of a birthday cake purchased from a bakery. An experienced tax practitioner would have encountered the same difficulty, but that fact was overlooked. Advertisements showed taxpayers shopping and receiving a docket with 'up 15%' superimposed on it. Again, this advertisement ignored the effect on prices of the abolition of many other taxes. In response to media and

[12] McKerchar M. 'The Effects of Complexity on Unintentional Noncompliance for Personal Taxpayers in Australia.' *Australian Tax Forum*, Vol 17, No 1, 2002, pp.1–24.

political pressure, Hewson was forced to issue Fightback Mark 2, which exempted basic foodstuffs from GST. The Labour party was returned to Office.

THE TAX LAW IMPROVEMENT PROJECT

In 1980 about 20% of taxpayers lodged their returns using the services of an agent. Twelve years later over, 72% did so. This figure has remained static. It refers to personal taxpayers. The percentage of business taxpayers who use an agent has always been about 92%.[13] In December 1993, the Government announced that there was to be a re-write of the Income Tax Assessment Act 1996. The terms of the re-write specifically excluded dealing with tax policy issues. The project was confined to rewriting of the ITAA 1936 in more simple language for the 'suburban tax practitioner.' The taxpayer in the street was abandoned as a target audience very early in the process. This better-written and designed Act was intended to be more easily understood therefore easier to use and less costly on compliance costs. A policy decision was taken for progressive enactment rather than a 'big bang' enactment once the entire Act had been rewritten. Two private sector representatives worked on the rewrite team and public information sessions were offered. The main problem was that practitioners were so overloaded with their regular work that only a few could participate in the consultative process.

Huge tranches of draft legislation were released annually about 23 December with an early February deadline for comments. Practitioners were frustrated that glaring policy problems were not rectified, but the government felt that if policy issues were to be dealt with no progress would be made. That was a reasonable attitude. The Taxation of Financial Arrangements legislation has been an important policy issue since 1993 and no final legislation or code has appeared yet.

About one third of the ITAA 1936 was rewritten when the current government announced in 1997 that there would be a new Review of Business Tax. The Income Tax Assessment Act 1997 replaced the rewritten parts of the ITAA 1936. ITAA 1997 is written in plainer language, and contains flow charts, diagrams, non-operative provisions and examples. Improvements to the text were made in the course of the rewrite. The first draft of the core provision on assessable income comprised thirteen pages. The income section consisted of 5 lines in ITAA 1936. What is now called the 'Dictionary' was originally called the 'Toolbox', and the word 'taxpayer' was abandoned in favour of 'you'.

[13] Bird, S. 'Helping Tax Agents Help Taxpayers.' *Australian Taxation Office Research Conference* (Canberra) 2–3 December, 1993.

THE REVIEW OF BUSINESS TAX

In August 1997 the Howard Government announced a review of the Tax System, to take place under the chairmanship of company director John Ralph. What Australia needed was 'A New Tax System' (ANTS), not a new tax.[14] Major issues were:

1. No increase in the overall tax burden.
2. Major reductions in personal income tax.
3. Change to the system of indirect taxes.
4. Appropriate compensation where necessary.
5. Reform of Commonwealth/State relations.

The section on tax administration found it to be too complicated; the burden on taxpayers in relation to compliance was held to be unfair; laws were too complex, therefore advising had become an impossible task; and tax avoidance and the cash economy were growing.

As with the 1985 Draft White Paper the proposals came from a team of people within Treasury and the ATO, with minimal private sector involvement.

As an equity measure, a new system of common entity taxation was to be established, but has been abandoned as too difficult to achieve. The issue which captured the attention of the electorate was the introduction of a Goods and Services Tax at a flat rate of 10%. The revenue from GST was to be given to the states. One controversial proposal was the suggestion of rewriting all the core income provisions and introducing a single system of calculating income known as the Tax Value Method. A newly constituted Board of Taxation had been conducting research into the viability of the proposal. The Ralph measures were to be introduced as a single package. Instead they were enacted on a piecemeal basis. A proposal which has been enacted was the abolition of indexation on capital gains, being replaced by a 50% discount from any gains made from the sale of property which has been held for over a year. This led to a re-emergence of the pre-1985 tax planning strategy of converting assessable income into capital. Previous research had shown that CGT reached its target – it was paid by wealthy people who would previously have paid no tax. It was equitable and an excellent revenue raiser.

THE CURRENT POSITION

Not many of the Ralph proposals have been introduced. The amendments to CGT have been popular with those who derive capital gains, and the

[14] Review of Business Taxation, *A Strong Foundation; Discussion Paper Establishing Objectives, Principles and Processes*. Canberra: AGPS, 1998.

small business sector has enjoyed generous concessions on retirement. The compliance burden imposed by GST has been predictably large and, as is the case everywhere in the world, it has not led to a diminution in the cash economy. Legislation is still complex. Over 20 000 rulings were issued in relation to GST before the legislation came into force on 1 July 2000. With hindsight most of the measures suggested by Ralph are anti-avoidance ones.

The ATO's most recent project is called 'Listening to the Community.' That is reminiscent of the measures introduced in the late 1950s when Patrick McGovern was Commissioner. The ATO offers regular consultative meetings which it feels are useful. Private practitioners who attend these meetings claim that they are frustrating and rarely lead to achievable outcomes. There has not been a non-government review of the tax system since the Asprey Report in 1975. Apart from media input, there has been no community involvement in tax reform since the Tax Summit in 1985.

The ATO has a very difficult task. Australians tend to have a cavalier attitude towards authority and virtually everyone participates in the cash economy when opportunity presents itself. The ATO cherishes an anecdote from the early seventies when Sir Edward Cain was Commissioner. A tradesman who was in ignorance of his client's position requested cash for some work he was doing at the Cain family home. He used the phrase 'I want to keep the tax man off my back.' Sir Edward, without revealing his identity, apologised and offered the tradesman a cheque.

TAX AVOIDANCE IN THE LATE 1990S

In the nineties, there has been a rise in mass marketed tax schemes. These were sold extensively in mining towns. Some local practitioners advised that the schemes could be successfully attacked under Part IVA, the current general anti-avoidance provision. Many taxpayers chose to ignore this warning, bought into the scheme, varied their income tax deduction instalments and paid no tax. A few years later when the ATO brought actions there was a media outcry because the taxpayers were facing huge bills for the unpaid tax, the interest and penalties due. As a result of the media outcry the ATO offered to withdraw all penalties and interest and permit taxpayers to repay the unpaid tax over a two year period. It was a very fair offer to solve an administrative disaster. In return, taxpayers gave up their rights of appeal regardless of subsequent court decisions.

To date the ATO has won the two cases it has brought – *Howland-Rose & Ors v FCT* (2002) 49 ATR 2006 and *Vincent v FCT* (2000) 50 ATR 20. There is no doubt that the ATO was slow to act to warn taxpayers that it was planning to disallow deductions to people who had invested in the schemes. The media portrayed it as a 'little person's opportunity' to be

involved in a business and to have some of the advantages of tax planning which are normally only available to the wealthy.

POLICY INITIATIVES OF THE ATO

In theory the government, advised by Treasury and on occasion the private sector, develops tax policy. The Office of Parliamentary Counsel produces legislation to give effect to the policy and the Australian Taxation Office administers that policy. In practice, as this paper demonstrates, there is no comprehensive policy development process in Australia. Policy is developed in a rush, in response to electoral pressures, and usually with little or no private sector input. The ATO denies that the current tax climate is adversarial, but tax practitioners are struggling to come to terms with the new tax system and feel abandoned. The Institute of Chartered Accountants announced on Tuesday 13 August 2002 that if major systemic problems are not fixed within ten weeks its members will go on strike and flood the ATO with endless paper based returns. Most practitioners have been working seven day weeks for the last three years. The quarterly Business Activity Statement (BAS) which was introduced with the GST and the new Pay As You Go collection process has quadrupled the number of returns to be lodged for many taxpayers.

The BAS form was badly designed. To avoid the necessity of lodging quarterly statements, the government offered taxpayers the opportunity of paying instalments based on their December quarterly figures, and lodging one annual return. Most small businesses rejected that concession because December is traditionally their best month and therefore not an appropriate measure of their turnover.

When the ATO identifies policy issues or major systemic administrative problems, it has two possible courses of action:

1. Amendment of the Act to prevent in the future undesirable taxpayer behaviour.
2. Introducing pre-emptive anti-avoidance legislation.

It is difficult to determine whether the course taken by the ATO is a response to taxpayer behaviour, or the result of a suspicious attitude in relation to taxpayer behaviour.

The ATO is subject to resource problems. In August 2001 the Government forced major downsizing in the ATO and over 1400 officers left the employment of the ATO. In August 2002, an enquiry into ATO practices and staffing levels forced the government to acknowledge that more staff were needed and active recruitment took place.

The ATO is inevitably criticised. It is in a similar position to all service providers – every improvement rapidly becomes accepted as the norm and

further improvement is demanded. Its lack of resources constrains its ability to do field audits. Therefore it develops legislation which it hopes will prevent non-compliant behaviour. Two recent examples of ATO policy initiatives are the introduction of:

1. Legislation dealing with Non Commercial Losses; and
2. Legislation covering Alienation of Income and Personal Services Income.

NON COMMERCIAL LOSSES

Division 35 ITAA 1997 contains rules designed to prevent individuals from deducting losses from non commercial activities against income from other sources. Before the introduction of Division 35, high net worth earners would run a small business as a sideline, e.g. primary production (hobby farm), share trading and deduct the losses from that activity against their other income. Division 35 ensures that loss is quarantined against future income from the non commercial activity. The ATO is confident that the legislation is an improvement on previous law as it clarifies exactly what constitutes a business for the purposes of tax deductibility. Division 35 denies the deduction in cases such as *Walker*.[15]

Under Division 35, the loss is able to be claimed if the taxpayer passes one of four tests. The underlying policy was to prevent 'Pitt Street' farmers, who ran hobby farms on weekends, from taking advantage of tax benefits offered to primary producers. Today these people are usually wealthy having derived their income form other sources and easily pass the tests in the division such as the assets test and the minimum capital contribution test. Instead it is often genuine taxpayers who are operating in an arm's length situation who fail to pass the tests, for example taxpayers in the services industry often do not pass the assets test.

Similarly, the Personal Services Income legislation affected many people at whom it was not intended to be directed. The government therefore had to amend the legislation to allow taxpayers to self assess, if they were conducting a personal services business.

INTEGRATED TAX DESIGN

The Review of Business Taxation Committee in its initial consultation paper suggested that Australia adopt an integrated approach to tax design.

[15] *Walker v FCT* (1983) 14 ATR 75.

In its final report, *A Tax System Redesigned*,[16] the Review recommended[17] that the starting point of this approach:

> *... must be the establishment of agreed national tax objectives and deriving from these objectives a principle-based approach to the design of business tax policy, legislation and administration.*

In order for integrated design to be successful, all stakeholders in the system must work co-operatively to achieve:

1. Shared ownership of the issues;
2. Clear accountability;
3. Open communication;
4. A commitment to co-operation;
5. An ability to think systemically; and
6. An ability to work across organizational boundaries.

In addition there must be feedback loops so that policy formulation, legislative drafting, administration (including systems design) all work together to ensure that the policy is effectively implemented. Integrated tax design envisages that government departments work co-operatively with external specialists.

These recommendations were not adopted by the government and often the legislation flowing from the Review of Business Tax did not adequately deal with the original underlying policy. This required the ATO to alter the legislation or provide administrative solutions. An example is found in Division 35, which covers non-commercial losses.

The ATO voluntarily adopted an integrated tax design approach when developing the legislation for the consolidation of company accounts. Those who were involved in the process found it a very positive experience. It is uncertain whether the commitment to the integrated approach will be able to continue. ATO tax policy specialists have moved to the Treasury Department and the senior ATO officer who was in charge of the Integrated Tax Design project has recently retired. Some practitioners are concerned that this could mean that there will be less open discussion as all public sector involvement is concentrated in the Treasury.

CONCLUSION

Throughout the decades, Australia's tax policy has been the result of a random or politically driven process. The traditional role of the ATO

[16] Canberra: AGPS, 1999.
[17] Recommendation 1.1. For a full discussion of this area see Dirkis, M. at note 6.

has been to pursue taxpayer compliance, often through the enactment of specific anti-avoidance legislation. Its scarce resources and the lack of field officers available to conduct an audit make this approach cost effective. The administrative style of the ATO has fluctuated between aggressive and helpful. The ATO maintains that a mixture of the two achieves the best compliance outcome. Tax behaviour affects the balance between assistance and enforcement. Over complicated and poorly designed legislation leads to a lack of taxpayer and community confidence in the tax system. The Annual Reports of various Commissioners demonstrate, however, that the relevant issues remain unchanged. The Commissioner's current 'Listening to the Community' project operates in conjunction with his legal challenges to the mass marketed schemes.

14

The Long and Winding Road: A Century of Centralisation in Australian Tax

RODNEY FISHER AND JACQUELINE MCMANUS

THE LONG AND WINDING ROAD: A CENTURY OF CENTRALISATION IN AUSTRALIAN TAX

ABSTRACT

WHEN AUSTRALIA BECAME a Federation in 1901, the newly created Federal government was granted a non-exclusive income taxation power, with the States retaining a residual taxing power. However by the end of the century the Federal government had effectively secured control of income tax and most indirect taxation. This paper charts the path by which this transformation in power was achieved.

It was not until the funding exigencies created by the First World War that the Federal government first imposed income taxation. The Second World War then created an opportunity for centralisation of income taxation at the expense of the States. While Federal priority in income taxation was introduced as a war-time measure, the government proved reluctant to surrender its hard won gains. The centralisation of income taxation has carried with it control of the distribution of funds raised.

The introduction of a GST, imposed by the Federal government although ostensibly State controlled, has effectively garnered almost exclusive power for direct and indirect taxation in the hands of the Federal government.

INTRODUCTION

From the time of Federation of the Australian colonies, there has been tension surrounding the relationship between the governments at the State and Federal levels in balancing revenue and responsibility. While the

Constitution[1] granted the Commonwealth a non-exclusive income taxing power,[2] the power to impose customs and excise was exclusive.[3] This inability of the States to levy excise duties greatly restricted the taxes they could impose, and yet the responsibilities allocated to the States were not similarly restricted.

Despite the non-exclusive income tax power, the Commonwealth government has been able to effectively centralise the imposition of income tax in Australia, with the sanction of the *Constitution* and the courts, and this paper charts the path by which that has been achieved. The path to centralisation commenced with the move to Federation, and while the Commonwealth may have been slow in exercising its income taxing power, once driven by the exigencies of war to use the power for revenue purposes there is arguably an almost inexorable path leading to the effective centralisation of the levying of income tax in the hands of the central government.

With States being effectively, if not legally, excluded from levying income tax, the equally vexed question arose of State funding. Initially the Commonwealth made grants to the States in the form of unconditional payments, although over time conditions as to how the money should be spent were attached. As a result, the Commonwealth was able to set the agenda for legislation even in areas outside its constitutional jurisdiction. Recent changes to Commonwealth-State financial relations attempt to address these issues by unconditionally allocating GST revenue raised by the Commonwealth to the States.

COLONIAL TAXES

The imposition of income tax for the purpose of raising revenue was not an early priority in the colonies, with funding available from the levying of customs and excise duties, and from the sale of public land. The first colony to adopt a comprehensive income tax was South Australia, where a growing public debt could not be met by the excise on alcohol and tobacco, as '… the abstemious South Australians used too little of these commodities to make a tax worthwhile.'[4]

While budget deficits in the colonies forced governments to attempt to introduce direct taxes, generally in the form of land and income taxes, the bicameral legislatures acted for some time to thwart these efforts. The taxation of income and land were often readily accepted in the lower

[1] *Commonwealth of Australia Constitution Act* (63&64 Victoria, Chapter 12), herein referred to as the *Constitution*.
[2] *Constitution*, s 51(ii).
[3] *Constitution*, s 90.
[4] Fayle R, (1984) 'An historical review of the development of income tax in Australia', *Taxation in Australia*, February Vol 18, p 666 at 673.

houses which were elected under universal adult suffrage, while the upper houses, elected on a more restrictive property franchise, resisted such attempts until forced by economic necessity to accede to such measures.

Over a period all colonies followed the lead established by South Australia in imposing income taxes, and by the early 1900s the levying of income taxation by the States had become firmly entrenched, and would not be lightly surrendered.

FEDERAL CONSTITUTIONAL POWER

Given that by the time of Federation the colonies were moving towards a greater reliance on revenue raised from income taxation, it may seem anomalous that they would be prepared to allow such a power to be concurrently held by the proposed Commonwealth government. The path towards this granting of power to the Commonwealth is one of political brinkmanship, with compromise based on expediency and practicality. Some of the developments towards granting the new Commonwealth the taxation powers with which it was bestowed are outlined below.

Constitutional Conventions

The path to Federation was marked by a series of Constitutional Conventions, the final outcome from which was the *Commonwealth of Australia Constitution Act* (63&64 Victoria, Chapter 12) presented to the British Parliament.

It would appear that in delineating the powers to be conceded to the new Commonwealth Government, the Conventions accepted that the power to impose taxation was among the first to be included, with the draft bill presented by Sir Samuel Griffith to the 1891 Sydney Convention conferring on the Federal legislature the power for 'Raising money by any mode or system of taxation; but so that all such taxation shall be uniform throughout the commonwealth.'[5]

Limitation of Taxation Power

Rather than the contentious issue being the granting of the power to impose taxation to the Commonwealth, the matter attracting debate at the conventions centred on whether such power should be limited or at large.

[5] Draft bill s 52(3).

Concern was expressed by some delegates that granting an unlimited taxing power, in conjunction with the power to levy customs and excise duties, was premature, with the suggestion being that the power be withheld until allocation to the Commonwealth of the duties to be discharged in connection with the power.[6]

However the prevailing view considered that the Commonwealth power of taxation should be an unlimited power, largely on the basis that the objects of the Federal government were unlimited, requiring a coexistent unlimited power of taxation. Indeed the argument was submitted that '... to limit the greatest and necessary power of any state, the power of taxation, which lies at the bottom to a certain extent of all government, would be to at once stultify the whole constitution you bring into existence.'[7]

The recognition of the critical importance of defence was also raised in support of unlimited taxing power, the requirement being that '... unlimited power of taxation must accompany the unlimited responsibilities of the commonwealth. One of the foremost of its duties ... was to provide for the common defence of Australasia, and it may be necessary to devote not only the last ship, but the last shilling to that object. It is impossible to cast the duty of defence on the commonwealth without giving them unlimited taxing power.'[8]

Residual Power for States

A second issue concerning some delegates related to whether the Commonwealth taxation power would be exclusive[9] or coexistent with State power. Reassurance was given that 'With regard to direct taxation ... the colonies will possess in future every power which they now possess.'[10] Further, 'There is no doubt that all the parliaments of the states will have precisely the same powers of (direct) taxation as they have at present ... It is possible that both parliaments might impose taxes on the same thing. That cannot be helped.'[11]

In what may be seen as an expression of confidence in future Commonwealth governments, or as exhibiting a degree of political naivety, Sir Samuel Griffith also expressed surety that '... the federal parliament would never impose direct taxation excepting in a case of great national urgency.'[12]

[6] *Official record of the debates of the Australian Federal Convention, Vol I Sydney 1891*; see for example Sir John Bray at 671.
[7] Above note 6, per Mr McMillan at 671.
[8] Above note 6, per Deakin at 675.
[9] As was the Commonwealth power to levy customs and excise duty.
[10] Above note 6, per Deakin at 674.
[11] Above note 6, per Griffith at 907.
[12] Above note 6, per Griffith at 907.

Interpretation of the Power

In relation to the scope of the taxation power,[13] the view following from the Conventions saw 'The power which is the sinews of all government ... granted in the most unqualified terms, separately and not as a mere incident to other powers of the Commonwealth.'[14] Reinforcing his views expressed at the Convention, the now Chief Justice Griffith highlighted the Federal and not unitary purpose of the *Constitution* in *Municipal Council of Sydney v The Commonwealth*,[15] with Federal and State taxation powers not competing but being '... concurrent and independent powers.'[16]

DEVELOPMENTS PRE-WORLD WAR I

For the first ten years after Federation the finances of the Commonwealth were almost wholly based on revenue from customs and excise duty. At least three quarters of the collections were assigned to the States in compensation for lost revenue from customs and excise duties previously levied by them.[17] The Australian governments seemed to hold the view that Commonwealth payments to States should directly relate to the financial sacrifice brought by Federation to a State. This arrangement however left the States largely at the mercy of the Commonwealth. As the scheme was considered less than optimal, it was therefore implemented as an interim arrangement and subject to change. The scheme was to span 10 years only.

During this period the Commonwealth made no attempt to introduce an income tax, largely since the revenue requirements did not dictate the need for such a tax.

State Grants

Given the rather temporary nature of the grant arrangements at this stage, several substitute systems were discussed at length at Premiers' Conferences, but to no avail. However one common theme did emerge from the discussions. It was agreed that the distribution of Commonwealth payments should be on a per capita basis, rather than a percentage of customs and excise receipts. Accordingly legislation in 1910 provided for a flat amount of 25 shillings per capita. The amount was again granted for ten

[13] Section 51(ii) of the *Constitution*, provides the power for 'Taxation; but not so as to discriminate between States or parts of States'.
[14] Harrison Moore W, *The Constitution of the Commonwealth of Australia* 2nd edn, Sweet & Maxwell, Melbourne 1910, p 505.
[15] (1904) 1 CLR 208.
[16] Above note 15, per Griffith CJ at 232.
[17] *Constitution*, s 87 (often referred to as the Braddon clause).

years 'and thereafter until the Parliament provides.'[18] The introduction of the per capita grants resulted in a reduction in payment to the States. This shift was responsible for the invention of special grants.

Special grants were provided on the basis that some States made larger per capita contributions to the customs revenue and should be compensated accordingly. Western Australia received special grants in 1910–11 on this basis, Tasmania in 1912 and later South Australia in 1929. Although the Commonwealth paid these special grants, it was of the opinion that they were of a temporary nature.

WARTIME BEGINNINGS

In 1915 the first *Income Tax Assessment Bill* was introduced, passing into law in only three weeks.

While the taxation measures were undoubtedly designed for their fiscal effect of financing a shortfall in funds in the expenditure required for the war effort, despite UK loans, the Second Reading Speech of Labour Attorney-General Hughes does provide a hint of potentially deeper motives. In outlining the circumstances which required the new taxation measures, he noted:

> That additional revenue is necessary to meet the great and growing liabilities of the War is amply apparent. … I have always regarded this form of direct taxation as peculiarly appropriate to a modern community, and if the incidence of tax be based upon sound principles, not only an effective means of raising money for the conduct of the government, but serving as an instrument of social reform.[19]

While assuring that 'The Bill, of course, is frankly a War measure designed to meet the present circumstances,'[20] the *Income Tax Assessment Act* was amended before the end of the session of Parliament in which it was introduced, thus establishing a great Australian tradition of regular and frequent amendment to income tax laws. Additionally, the rates of income tax[21] increased in 1916, 1918, and 1920, and the war measure has survived into the next century.

With the introduction of this Commonwealth income tax, both the Commonwealth and States now imposed separate and distinct income taxes.

[18] It was proposed that this arrangement be made permanent through an amendment to the *Constitution*, however the referendum was defeated. The provisions therefore were made through legislation, namely the *Surplus Revenue Act* 1910.
[19] Mills S, *Taxation in Australia* at p 237.
[20] Above note 19, at p 238.
[21] Rates were prescribed by the *Income Tax Act* 1915.

While this may have created practical difficulties, there was no legal impediment as the power for the Commonwealth to levy tax was not an exclusive power except in limited areas such as customs and excise.[22]

POST-WORLD WAR I PROGRESS

Taxation

Following the Commonwealth imposition of income tax in 1915, taxpayers were faced with filing two separate income tax returns for their State and Federal income taxes. Despite attempts to harmonise these taxes little progress was made, although in respect of administration of the dual taxes the Commonwealth administered and collected State income taxes for Western Australia.[23]

The final report of the Kerr Royal Commission into income taxation in 1923 rather prophetically recommended an allocation of direct taxing powers between the Commonwealth and States, with the Commonwealth taking an exclusive income taxing power, and the States an exclusive power for other direct taxes. While such a radical proposal would not be accepted (by the States), a further Conference of Commonwealth and State Ministers in 1923 did reach a basis of agreement in that the States, with the exception of Western Australia, became agents for the collection of Commonwealth income tax. As part of this agreement, the States took over Commonwealth taxation staff and resources, with the benefit for taxpayers being that only one income tax return (per State) needed to be prepared.

In a further attempt to harmonise the various income taxes, 1932 saw the appointment of another Royal Commission (the Ferguson Commission), which recommended the adoption of uniform legislation and administration by the Commonwealth and States. The outcome from this was the *Income Tax Assessment Act* 1936, and while uniformity reigned for a short time, a diversity of amendments reintroduced differences between the Commonwealth and States.

New Framework for Fiscal Federalism

In 1926 the Commonwealth announced the termination of per capita subsidies. A new framework for fiscal federalism was developed, the main focus of the scheme being government debt. The State debts were taken over by the Commonwealth, and State borrowings were placed under

[22] *Constitution* s 90.
[23] vanden Driesen I & Fayle R, 'History of income tax in Australia' in Krever R (ed) *Australian Taxation: Principles and Practice.*

a newly formed Loan Council.[24] An annual grant was established for the servicing of State debt. This annual grant was set at the existing level of per capita grants and was to grow with population. Consequently what was previously an unconditional grant had been converted to a conditional specific grant. This framework was set out in a Financial Agreement in 1927. It provided for 58 years. A sinking fund was also established to compensate States for any loss as a result of the new scheme.

The Agreement was ratified by constitutional amendment which in turn gave States constitutional claims to Commonwealth revenue for the first time.[25] State borrowing (except temporary borrowing) from this time forward was dependent on the approval of the Loan Council. The Council was given full legislative and Constitutional status. There is no ability to appeal against its decisions, as it is not directly responsible to any one Parliament or electorate.

Commonwealth Grants Commission

Additionally, around this time it was argued that all special grants should be applied for and considered by the same person or persons rather than operate through ad hoc bodies as had been occurring until this time. This view was accepted in 1933 when the Commonwealth Grants Commission was established.

The purpose in establishing the Commonwealth Grants Commission was to achieve uniformity and to clarify and develop the principles for determining State special grants. The method developed involved comparing the budgetary circumstances of the States claiming special grants with those of the other, so called 'standard States'.

While the method was modified over time, the underlying principle remained that of ensuring a claimant State had the financial capacity to provide the same range and quality of services as the standard States, provided it imposed the same range of taxes and charges at the same rates. The Commission's calculations were based on the principle of fiscal equalisation which states that:

> Each State should be given the capacity to provide the average standard of State-type public services, assuming it does so at an average level of operational efficiency and makes an average effort to raise revenue from its own sources.
>
> Equalisation is designed to equalise States' capacity, not their results. This is because the Commission's recommendations relate to untied general revenue grants and each State is free to decide its own priorities.[26]

[24] The Loan Council was established in 1928–29 to handle all borrowing by Commonwealth and State governments except temporary borrowing or Commonwealth borrowing for defence.
[25] Refer *Constitution*, s 105A, inserted by *Constitution Alteration (State Debts)* 1928.
[26] www.cgc.gov.au.

The Commonwealth Government accepted the Commission's recommendation although it was not entirely satisfied with the principle of financial need adopted by the Commission.

WAR TIME MEASURES (THE PENULTIMATE ENGAGEMENT)

The success of the 1927 Financial Agreement was thwarted by unrelated world events. The depression of the 1930s, followed by the Second World War, caused the Commonwealth Government to take drastic measures in relation to finances.

In 1941 the Commonwealth unsuccessfully offered the States a grant in compensation for withdrawing from income taxation. A further unsuccessful attempt to get the States to relinquish their income taxes was made at the 1942 Premier's Conference, despite the added guarantee that the States would have the right to again impose income tax after the war.

To meet the exigencies created by the funding requirement for the war effort, the Commonwealth finally took matters into its own hands in 1942 and introduced four Bills which were enacted as:

- the *Income Tax Act* 1942; which set an income tax rate higher than the combined existing State and Commonwealth rates;
- the *Income Tax Assessment Act* 1942; which gave priority to payment of the Commonwealth income tax over State income tax;
- the *States Grants (Income Tax Reimbursement) Act* 1942; which provided for Commonwealth financial assistance to those States which did not impose their own State income tax; and
- the *Income Tax (War Time Arrangements) Act* 1942; which allowed for the Commonwealth to take over State income tax officers, premises, equipment, and records.

The latter of these measures may appear rather ironic, given that there had been a transfer of Commonwealth taxation resources to the States as a result of the 1923 agreement, and now these State resources would be transferred to the Commonwealth.

The practical result of these measures was to effectively reserve to the Commonwealth the exclusive power to raise income taxes, thus achieving for the Commonwealth, albeit by a rather circuitous path, a power which had been recommended by the Kerr Royal Commission some twenty years earlier.

The inevitable consequence of such Commonwealth legislation was the High Court challenge in *South Australia v Commonwealth*,[27] the basis of

[27] *The State of South Australia & Another v The Commonwealth & Another*; *The State of Victoria & Another v The Commonwealth & Another; The State of Queensland & Another v The Commonwealth & Another; The State of Western Australia & Another v The Commonwealth & Another* 65 CLR 373.

the challenge being that the Commonwealth lacked the constitutional power for the legislative provisions that had been introduced.

In separate judgements, their Honours[28] considered each of the legislative measures, and the discussion follows the same format.

While the challenge to the legislation was argued on a myriad of fronts, the essence of the States' argument contended that the provisions were in breach of the *Constitution* since they were '… in fact a single legislative scheme, and that the substance, purpose and effect of it is to make the Commonwealth Parliament the exclusive taxing authority in the Commonwealth in respect of income tax, and to prevent the States from exercising their constitutional powers in relation to income tax,'[29] the effect being to weaken or destroy the constitutional functions or capacities of the States. Further, such a scheme demonstrated '… an interference with and a discrimination against the States,'[30] for which the Commonwealth had no constitutional power.

In arguing for the validity of the legislative measures it was suggested that:

> The Court is not concerned with the wisdom or fairness of the legislation. The only question is one of power. It is enough if the legislation can possibly operate for the peace, order and good government of the Commonwealth, whether with respect to defence, or taxation, or borrowing, or grants, or matters incidental thereto. If the legislation can possibly operate in respect of any one of these things, then the Commonwealth has power, and it does not matter whether it has used the power wisely or unwisely.[31]

Income Tax Act 1942

The Full Court found this Act to be a valid exercise of Commonwealth power, although there was not unanimity of reasoning.

Addressing the question of the purpose of the legislation, Latham CJ considered that neither the indirect effect nor the ultimate purpose could determine the validity of a statute, and the Act in question was '… merely and simply an Act imposing taxation upon incomes'[32] for which the Commonwealth had power subject to certain limitations, none of which had been infringed.

McTiernan J found this Act and the *Income Tax Assessment Act* 1942 justified not only by the taxing power in the *Constitution*, but also by the defence power, to which a wide interpretation should be applied. His Honour noted that while all powers in s 51 of the *Constitution* are at the same level, the defence power may justify temporary suspension of State powers in the interests of the preservation of the State. The power to legislate for defence, '… although it shows itself on the same level as the other

[28] Latham CJ, Rich, Starke, McTiernan and Williams JJ.
[29] Above note 27, *per* Ligertwood KC at 385.
[30] Above note 27, *per* Ligertwood KC at 389.
[31] Above note 27, *per* Ham KC for the Commonwealth at 398.
[32] Above note 27, at 412.

powers, has a deeper tap-root, far greater height of growth, wider branches, and overshadows all the other powers.'[33]

Because the Act imposed the same rate of tax on all incomes, Williams J was able to find that the Act was valid under the taxing power in that it did not discriminate between States or parts of States '... considered as geographical entities.'[34]

States Grants (Income Tax Reimbursement) Act 1942

The High Court by a 4:1 majority found this legislation to be a valid exercise of Commonwealth power.

Latham CJ found that the provision of grants to States did not purport to repeal State income tax legislation or require States to abdicate their power to impose income taxes. Rather, it offered an inducement to States not to exercise their (still existing) power to impose an income tax.

In relation to the argued discrimination between States, his Honour found that while the States may receive varying amounts of grant, the '... indirect effect of varying grants upon the fortunes of taxpayers of different States is an irrelevant circumstance,'[35] and the Act operated without discriminating.

Williams J also found no illegal interference with the sovereignty of States, as the matter of whether they levied an income tax was left entirely to the discretion of the States.[36]

In a dissenting judgement, Starke J was not persuaded that the Act merely granted financial assistance to the States, but concluded that there was '... linked up in it an object and an end that is inconsistent with the limited grant of power given by s 96 to the Commonwealth, namely, making the Commonwealth the sole effective taxing authority if respect of incomes.'[37] Further, His Honour was of the view that the '... argument that the *State Grants Act* leaves a free choice to the States, offers them an inducement but deprives them of and interferes with no constitutional power, is specious but unreal.'[38]

Income Tax (War Time Arrangements) Act 1942

This Act would appear to have been the most contentious of the legislative enactments, being held valid by a 3:2 majority decision, both Latham CJ and Starke J dissenting.

[33] *Farey v Burvett* (1916) 21 CLR 433 per Higgins J at 455; in *South Australia v Commonwealth* at 451.
[34] Above note 27, at 462.
[35] Above note 27, at 427.
[36] Above note 27, at 463.
[37] Above note 27, at 443.
[38] Above note 27, at 443.

Rich J looked to a wide application of the defence powers as supporting the validity of the Act, finding that 'If the Commonwealth is to wage war effectively, it must command the sinews of war.'[39] A broad application was found for the defence powers, such that '… if the measure questioned may conceivably in such circumstances even incidentally aid the effectuation of the power of defence, the Court must hold its hand and leave the rest to the judgement and wisdom and discretion of the Parliament and Executive it controls.'[40]

While noting that the defence power did not become paramount in time of war,[41] Williams J had regard to the changing scope of the power, in that 'its application depends upon facts, and as those facts change so may its actual operation as a power enabling the legislature to make a particular law.'[42]

In his dissenting judgement, Latham CJ considered that the Act could only be supported by reliance on the defence head of power,[43] and while this power had been widely interpreted and applied, His Honour was unable to establish a sufficient connection with the legislation, since '… even this power has a limit – it is not sufficient to wave the flag as if that were a conclusive argument.'[44]

Also in dissent, Starke J was unconvinced that the defence power should be given broad operation. His Honour saw this Act as being '… wholly inconsistent with the exercise by the States of their powers, and of their functions as self-governing bodies,'[45] and the defence power, no more than any other power, allowed the Commonwealth to exercise power '… for ends inconsistent with the existence of the States or the exercise of their powers or their functions as self-governing bodies.'[46]

Income Tax Assessment Act 1942

This final Act was held to be a valid exercise of Commonwealth power, but not all judges were in agreement as to the reasoning to reach such a conclusion.

Latham CJ referred to the Canadian case of *In re Silver Brothers Ltd*[47] as being conclusive in regard to priority between taxes at different levels of government, finding as a consequence that the '… Commonwealth has power, by a properly framed law, to make Commonwealth taxation

[39] Above note 27, at 437.
[40] *Farey v Burvett* (1916) 21 CLR 433 at 455, 456 in *South Australia v Commonwealth* at 437.
[41] *Andrews v Howell* (1941) 65 CLR per Starke J at 268 in *South Australia v Commonwealth* at 467.
[42] *Andrews v Howell* per Dixon J at 278 in *South Australia v Commonwealth* at 467.
[43] *Constitution* s 51(vi).
[44] Above note 27, at 431.
[45] Above note 27, at 447.
[46] Above note 27, at 445.
[47] (1932) AC 514.

effective by giving priority to the liability to pay such taxation over the liability to pay State taxation.'[48]

McTiernan J relied not only on the taxing power, but also the defence power in finding this Act to be a valid exercise of Commonwealth power.

Post-War Challenge

The Commonwealth success against the judicial challenge of the States had the substance, if not the form, of effectively centralising the income taxing power in the hands of the Commonwealth government. However some of the newly validated Acts, in particular the *State Grants (Income Tax Reimbursement) Act* 1942 which provided grants to States which levied no income tax, and the *Income Tax Assessment Act* 1942 giving priority to Commonwealth income during the currency of the war, were temporary Acts with a limited life.

The *State Grants (Income Tax Reimbursement) Act* 1942 was to continue until the end of the war, and it was then replaced by the *State Grants (Tax Reimbursement) Act* 1946-1948 with unlimited duration. The *Income Tax Assessment Act* 1942 was also a war-time measure, being replaced by the *Income Tax and Social Services Contribution Assessment Act* 1936–1956, this Act being for the '... better securing to the Commonwealth of the revenue required for the purposes of the Commonwealth.'[49]

Not surprisingly the States took the opportunity of the new enactments to mount one last onslaught against what was seen as the centralist grab for income taxing power by the Commonwealth.

The Final Campaign

Yet again the Commonwealth found itself defending its income tax legislation against a State challenge,[50] this time before a differently constituted High Court[51] in *Victoria v The Commonwealth*.[52]

[48] Above note 27, at 435.
[49] Section 221(1) *State Grants (Income Tax Reimbursement) Act* 1942.
[50] While the tactical aim of the State challenge was directed towards challenging key sections in the hope of undermining the entire legislative scheme, it is possible to be left with the impression that the heart had gone out of the State fight - only two States were involved in the challenge, and only two Acts were under challenge; it may be that after some years in operation the other States had accepted that there were some practical benefits in centralisation.
[51] Dixon CJ, McTiernan, Williams, Webb, Fullagar, Kitto and Taylor JJ; only McTiernan and Williams JJ remained on the Court from the first State challenge.
[52] *The State of Victoria & Another v The Commonwealth*; *The State of New South Wales v The Commonwealth* 99 CLR 575.

While the challenge was directed towards specific sections of the Acts, the aim being to establish invalidity of key sections and thus undermine the whole scheme, the arguments did not differ significantly from those used in *South Australia v The Commonwealth*. The States argued that the operation of the enactments effectively converted taxation into an exclusive Commonwealth power, with the States being coerced practically, rather than legally, into not exercising their powers.[53]

The Commonwealth response suggested that the development of Commonwealth-State relations had been in the direction of interlocking responsibility rather than mutual non-interference, and '... the raising of substantial sums by the Commonwealth and their distribution by way of grants to the States is consistent with the letter, spirit, and essence of the Constitution.'[54]

As with the previous discussion, the decisions are examined in relation to each of the challenged Acts.

State Grants (Tax Reimbursement) Act 1946–1948

This Act was held to be valid by the whole Court, its basis being in s 96 of the *Constitution*,[55] with Dixon CJ, with whom Kitto J concurred, finding that the power to grant financial assistance to any State is '... susceptible of a very wide construction in which few or any restrictions can be implied.'[56]

McTiernan J also found that the power conferred by s 96 was a general power limited only by the scope and object of the power, and even if the Commonwealth created the need which it then met by a grant, the character of financial assistance remained unchanged.[57]

Having been involved in the earlier case of *South Australia v The Commonwealth*, Williams J found that the principle of *stare decisis* required the earlier judgement be followed.[58] This allowed for a wide interpretation of the s 96 power, being sufficient to validate the Act.

Income Tax and Social Services Contribution Assessment Act 1936–1956

This enactment did not fare as well in the High Court, with a 4:3 majority determining that s 221(1) of the Act, being the priority provision, was ultra

[53] Above note 52, *per* Sir Garfield Barwick QC for the State of Victoria at 583–4, 586.

[54] Above note 52, *per* K H Bailey, Solicitor General of the Commonwealth of Australia, at 592–3.

[55] Section 96: During a period of ten years after the establishment of the Commonwealth and thereafter until the Parliament otherwise provides, the Parliament may grant financial assistance to any State on such terms and conditions as the Parliament thinks fit.

[56] Above note 52, at 605.

[57] Above note 52, at 623.

[58] Above note 52, at 629.

vires, not being incidental to the Commonwealth taxation powers under s 51(ii).

Having noted the grave responsibility in departing from the decision in *South Australia v The Commonwealth*, Dixon CJ was prepared to do so with this Act, finding that the earlier decision stood alone without authority, and without the defence power as a basis the enactment no longer had a constitutional foundation. His Honour also considered that the previous decision had given an application to the constitutional doctrine of incidental powers which he believed to be unsound.[59]

Being one of the two judges to have sat in both cases, McTiernan J followed his decision in *South Australia v The Commonwealth*, finding that the taxation power alone was insufficient to validate the Act, and the defence power had provided validity for the 1942 Act, but this was no longer an available power. On this basis his Honour found the Act invalid.[60]

Williams J, as the other judge from the earlier case, found no reason to depart from his decision in the earlier case, thus dissenting in the instant case and finding the Act to be valid. Fullagar J, also in dissent, found no reason to depart from the earlier decision, as the substance of the legislation was precisely the same as that previously challenged, there being insufficient reason to overrule *South Australia v The Commonwealth*.

Despite the High Court finding the priority section of the *Income Tax and Social Services Contribution Assessment Act* 1936–1956 to be constitutionally invalid, the resultant practical effect has been the effective exclusion of the States from imposing income tax since 1942.

All States ceased to impose income tax and began to receive grants based on the average tax revenue raised by the States over the previous two years. This basis of calculating the grant was however unfavourable to both Victoria and New South Wales. In particular Victoria had imposed low tax rates (and made a low level of tax expenditure) despite its high tax capacity. The arrangement was neutral for South Australia and Tasmania. Queensland and Western Australia, in relative terms, were better off.

STRIKING A BALANCE: THE DISTRIBUTION OF FUNDS

The experience gained through the consideration and negotiations of grants from 1901 to 1941 in many ways impacted on the development of the funding machinations used to compensate the States for lost income tax revenue.

[59] Above note 52, at 616.
[60] Above note 52, at 625.

Tax Reimbursements (1946-59)

When the war ended, the Commonwealth announced at the 1945 Premier's Conference that war time arrangements were to continue. However in 1946 the Commonwealth offered a new basis of tax reimbursement based on the existing grant plus the excess of the 'adjusted social services expenditure' in 1944–45. This proposal was flatly rejected. After much discussion a subsequent proposal was accepted for a flat reimbursement for two years.[61] For subsequent years the total was to be increased according to a formula which accounted for growth in State population after 1947 and wages growth over the level of 1946–47. The division of the amount however was left to the States. The then Prime Minister, Mr Chifley asked States to confer, and to propose a possible formula for that division.

The war time approach based on previous State income tax collections was clearly an unacceptable method of distribution of Commonwealth funds given the inequities, especially in respect of Victoria. While a per capita distribution was favoured, it was considered that composition and density of population should also be taken into account. These views were endorsed by the Commonwealth Grants Commission and were supported by all States except Victoria. The use of 'adjusted population' was consequently used. Actual population was adjusted for children of school age (between 5 and 15 inclusive), and relative scarcity of population.

An additional complication was introduced to appease the States that were favoured by the existing allocation. The agreed 'adjusted population' formula was introduced by a gradual transition over ten years.

This arrangement was never considered adequate. In none of the ten years it operated after 1946 did the total paid to the States correspond to what the formula would have provided. However the formula was only changed once, in 1948, when the basic grant amount was increased. The impact of the change in wages was increased from 50 percent to 100 percent and the base wage year was changed to 1946–47.

States repeatedly made claims of severe financial needs. At the time, the Commonwealth had a particular concern for the impact the world turmoil might have on defence and had a wish to retain its dominance in finance. However the Commonwealth governments did make ad hoc annual additions to the reimbursements and frequently changed the basis of distribution of these additions as a result of the annual plea. Reasons supporting the claims included financial losses occasioned by the coal strike in 1949 and the basic wage increase in 1950.

In 1953 the distribution debate peaked when the Under-Treasurers put forward a table of five distribution methods that had in some form been used for supplements. The Commonwealth chose a basis much like that

[61] Originally £37m was offered but after long debate it was set at £40m.

used in 1952–53. Yearly supplements continued to be made and distributed by a formula which by now closely approximated adjusted population. In 1957–58 new 'additional assistance grants' were made. They were new in name although really were simply supplements.

Attempts at Resumption of State Income Tax

As the 1946 arrangement drew to an end there was much discussion about the possibilities of a new scheme to replace what was considered to be the completely unsatisfactory current system. Not surprisingly the resumption of State income taxes was raised and initially keenly supported by all States. Gradually however, the poorer States such as Tasmania expressed concerns. Tasmania for example would need to tax on average 50% more than New South Wales to raise the same revenue per person. The diminishing ability of tax reimbursements from the Commonwealth to meet State expenditure needs, however, maintained the desire of richer States to secure growing revenues from income taxes.

In July 1952 at the Conference of Commonwealth and State Ministers, the Prime Minister declared that serious consideration should be given to the resumption of income taxation by the States. The then Prime Minster, Mr Menzies was of the opinion that the current situation was unsatisfactory and that States should be given the opportunity to control their own budgets. Such an arrangement would not impact on special grants under s 96 of the *Constitution*, as recommended by the Grants Commission for Tasmania, Western Australia and South Australia.

The Secretary of the Commonwealth Treasury and the State Under-Treasurers were instructed to prepare a report on the technical problems envisaged by the imposition of income tax by the Staes. Some issues raised were whether:

- income be calculated on the basis of origin or residence – unless agreement was reached double taxation, complex administration and higher taxpayer compliance costs would occur;
- State tax rates were to be related to Commonwealth rates, and whether there would be a limit in combined State and Commonwealth tax rates; and
- a coordinated form of assessment could exist given the inability of one Parliament to bind another.[62]

The number of unresolved problems raised secured the existing position of unitary taxation and Commonwealth reimbursement.

[62] Commonwealth and State Treasury Offices, *Resumption of Income Tax by the States*, January 1953.

1959 Agreement (Financial Assistance Grants)

A special meeting of Commonwealth and State Ministers was held in March 1959 precipitated by the continued unrest of States with the financial relations with the Commonwealth. Queensland was on the brink of applying to the Grants Commission for a special grant and even Victoria threatened to apply on the basis that current distributions were made to the detriment of its population.

At the 1959 meeting several proposals were launched, only emphasising the lack of agreement among the States. New South Wales and Victoria were the only States in favour of the reintroduction of State income taxes by this time.

The Commonwealth decided to build a new scheme based on the existing structure while incorporating parts of different proposals put forward. This 'new' scheme comprised the following features:

- A new basic grant in place of the existing tax reimbursement grant and supplements;[63]
- Western Australia and Tasmania could continue to claim special grants via the Grants Commission;[64]
- The grants were renamed 'financial assistance grants' to remove any connotation of reimbursement. Clearly the grants were not reimbursements and had a distinctive redistributive nature;
- A single formula would be used to calculate the grant for each State (as opposed to the previous system which required two formulas, one to calculate the aggregate and one to allocate this aggregate to the States);
- The grant for each State after the base year, 1959–60, was to be increased in proportion to the annual increase in population from 1 July and the increase in average wages plus ten percent for Australia during the preceding financial year. The 'betterment factor' of ten percent added to the overall wage increase was partly in compensation for the time lag and partly a bonus; and
- The arrangement was to continue for six years.

Despite the fixed nature of the six year agreement, circumstances were such that the States fought for and received supplementary payments in three of the six years.

[63] The basic grant was set at £242.5m, in replace of the two grants which for 1958–59 totalled £205m.

[64] Queensland and South Australia were to retain the right to apply to the Grants Commission only if circumstances were such that there financial positions declined relative to the other States.

1965 Agreement

In April 1965 a preliminary conference was called to consider a replacement for the 1959 agreement. In June 1965 the Commonwealth proposed a similar arrangement with an increased betterment factor of twenty percent to apply to both population and average wage increases. After discussion and an agreement to increase the base for both Queensland and Victoria, this proposal was accepted for another five year period.

During the 1960s, the States had explored the possibilities of indirect taxation. However the constitutional restraints on State revenue raising powers have been exaggerated by the High Court's narrow interpretation of the States' taxing powers under the *Constitution*.[65] A string of High Court cases had defined excise duties very broadly to include any levy imposed on goods at any point in the production chain, thus severely limiting the States' options.[66]

Given the Court's broad definition of 'excise duties', a sales tax, retail tax or goods and services tax cannot be levied by the States. The States tried to work around the constitutional and political restrictions by inventing levies that did not offend the *Constitution*. To this end a stamp duty on receipts was levied, until challenged in *Western Australia v Hammersley Iron Pty Limited (No 1)* in 1969.[67] In that case, the validity of the legislation was said to be dependent on its criterion of liability, being the receiving of money or the issuing of a receipt.[68] This view was not accepted however. The duty was held unconstitutional and withdrawn from State taxes. The States experienced a similar result with respect to business franchise fees imposed on tobacco, petrol and alcohol in a later attempt to supplement revenue.[69]

Stamp duty on receipts for wages and salaries did remain valid, and two States levied such duties. However the Commonwealth in 1968 warned these States that this duty was an unacceptable form of income tax and if not repealed their financial assistance grant would be reduced in 1970. The Commonwealth itself had imposed a pay-roll tax since 1941.[70]

[65] See for example, *Parton v Milk Board (Vic)* (1949) 80 CLR 229.
[66] *Parton v Milk Board (Vic)* (1949) 80 CLR 229.
[67] *Western Australia v Hammersley Iron Pty Limited (No 1)* (1969) 120 CLR 42.
[68] Above note 67, at 63.
[69] The High Court of Australia brought down a combined decision in the cases of *Walter Hammond and Associates v State of NSW and others* and *HA and anor v State of NSW and others* in 1997 which declared franchise fees on tobacco invalid. As a result the States were forced to cease imposing this tax. Given the similar nature of charges imposed on petrol and alcohol the States also removed those fees at that time.
[70] *Pay-roll Tax Assessment Act* 1941.

Searching for Alternatives in the 1970s

In the late 1960s and early 1970s the system of financial assistance came under increasing criticism from State governments and academics. The States were concerned with the growing dependence upon Commonwealth grants. In the 1950s Commonwealth payments to States for recurrent purposes made up approximately 36% of State revenues. By 1974 these payments made up almost 50% of revenues. Moreover the specific purpose payments were increasing from less than 9% of revenue in the early 1960s to almost 25% in 1974. So the States not only relied on the Commonwealth for almost half their revenue but were also required to spend an increasing portion of it as directed by the Commonwealth. Suggestions for improvement in a system considered to be grossly inefficient were made, including:

- the introduction of a broad based growth tax by the States;
- a partial withdrawal of the Commonwealth from income tax to allow the States to resume income taxation; and
- allocation by the Commonwealth to the States of a certain proportion of tax collections from one or several sources.

The States turned firstly to the possibility of regaining some access to income tax and in 1970 unanimously suggested the financial assistance grants be replaced with a new scheme. This scheme would see the base of general revenue grants increased with future increases linked to increases in income tax yield, pending the partial withdrawal of the Commonwealth from income taxation to allow the States to levy their own. The Commonwealth rejected this plan although did agree to increase financial assistance grants. It also offered to partially take over State debts and make capital grants.

In 1971 the States finally were able to access a growth tax to compensate for lost revenue from the withdrawal of the receipts duty when the Commonwealth decided to transfer pay-roll tax to the States for an offsetting reduction in the financial assistance grants. The States agreed, and on taking over the pay-roll tax all States unanimously increased the tax rate.

When the financial assistance grants were reviewed in 1975 the States no longer suggested their own income tax. Instead they suggested amending the formula for calculating grants by substituting the wages element for 1.5 times the percentage increase in average wages. While this was rejected, the Commonwealth did increase the financial assistance grants and increased the betterment factor in the formula from 1.8 to 3 per cent.

Income Tax Sharing (1976)

Premiers' conferences were held in February and April 1976 to agree the details of the new government's 'new federalism' policy. These meetings

culminated in thirty five 'Points of Understanding.'[71] As a result, the financial assistance grants were replaced in 1976 by a system of personal income tax sharing. In accordance with the Points of Understanding the States received a fixed percentage of the personal income tax collected by the Commonwealth.

In the second stage of the scheme introduced in 1978, each State was able to impose a surcharge or grant a rebate in the Commonwealth rates of taxation.[72] In either case the Commonwealth was to act as agent for the State. None of the States imposed a surcharge or granted a rebate. This power was removed in 1985.

The decision as to how much of the personal income tax revenue would be available to the States was a political decision. The Commonwealth Grants Commission would determine the distribution of tax among the States and the allocation of each State's share to individual local governing bodies was to be carried out by State grants commissions, to be established under State legislation.

For the first four years there was also a guarantee made that the amount received by each State would not be less than that payable under the previous arrangement. Every State except Queensland required additional payments under the guarantee in the first year. Problems also arose in respect of timing and certainty of amounts for budget purposes which brought about a change in the arrangement. The Commonwealth and the States subsequently agreed that the fixed percentage would be applied to the previous years personal tax collections rather than those of the current year. Although the Commonwealth decided to make 33.6% of personal income tax collections in a year available to the States in that year, a total of 39.87% of the previous years personal income tax collections was actually paid since the guarantee was invoked every year (until it ceased in 1980).

Review of Distribution

Although the distribution among the States was initially based on the previous financial assistance grants, the Points of Understanding provided for a periodic review of the arrangements as a whole, with the first review to take place before the end of the 1981 financial year. The Commonwealth and the States were unable to agree upon a suitable review body until late in 1977. It was then agreed that the task should be undertaken by the Commonwealth Grants Commission. The Commission's review, which took more than two years, was completed in June 1981.

[71] The Points of Understanding were released in Commonwealth Budget Paper No 7, *Payments to or for the States and Local Government Authorities 1976–77*, pp 15–18.
[72] Under *the Income Tax (Arrangement with the States) Act* 1978.

The Commission's report recommended a change in relativities on the basis that the shares of New South Wales, Victoria and Queensland were inadequate and the shares of the other three States were excessive. After consideration of the report of the Commonwealth Grants Commission at a Premiers' Conference, the States did not accept the findings unanimously. The Commission was directed to review its findings in the light of a further year's data, any evidence presented by the States, and the new distribution arrangements for health grants.

As a result of the recommendations, and following discussions, the Commonwealth Government decided to change the arrangement, shifting from personal income tax sharing to total tax sharing. The main taxes included in the base were income taxes, sales tax, customs duty and excise duties.

Special grants could still be claimed by the four claimant States up to 1981, the completion date of the first review. According to the review the special grants could no longer continue and were consequently removed. Queensland was the only State to apply for and receive such a grant during the period 1967–1981.

When the second review was considered in 1982, a system of triennial reviews of the relativities was introduced and a Third Review Report was produced in 1985. When the third triennial review was underway in 1988, governments agreed there would be a change to a system of annual updates of the calculation and regular reviews of the methods of assessment to reduce the use of out of date information.

The Return of Financial Assistance Grants (1985 to 1999)

In 1985 the arrangement again changed. The concept of financial assistance grants growing at a specified rate was restored in the May 1985 Premiers' Conference. The grants continued to grow until the 1999 year with the exception of 1990–91 year when the grants were capped as a result of the recession experienced in that year.

Towards 2000 and Beyond

In 1991, the then Prime Minister, Bob Hawke suggested to the State Premiers a new 'Fiscal Federalism', where the Commonwealth would still collect the taxes, but predetermined amounts of revenue would then be distributed to the States, which they would be able to spend in any manner they chose. Although no agreements were made, discussions along these lines continued.

In 1998 the Commonwealth Government, led by Prime Minister John Howard, announced its plan to reform the Australian tax system. The Government indicated that 'A key element of *A New Tax System* was a landmark reform of Commonwealth-State financial relations.'[73] One of the significant outcomes of this initiative has been the introduction of a goods and services tax (GST) on 1 July 2001. As indicated previously, the States are precluded constitutionally from imposing a goods and services tax, so the Commonwealth Government has agreed with the States to effectively levy such a tax on their behalf. Some of the conditions of that agreement include the abolition of various State taxes in return for a share in the GST revenue.

Financial assistance grants ceased on 1 July 2000, however the replacement revenue (generated from the GST) is distributed to States on the same basis. Consequently the Commonwealth Grants Commission's work will continue in determining relativities between States based on the equalisation principle. The amount to be distributed is to be determined by the Commissioner of Taxation in accordance with Appendix B of the Intergovernmental agreement.

The Intergovernmental agreement is contained in *A New Tax System (Commonwealth-State Financial Arrangements) Act* 1999. The agreement specifies that all proceeds net of cost of collection will be transferred unconditionally to the States. The allocation will be based on a formula set out in the agreement. Additionally, any changes to the base and or rate of GST must be agreed amongst the States in accordance with the Agreement.[74]

In the first three years after the introduction of the GST the Commonwealth has also undertaken to ensure that no State will be worse off, in that they will not receive less from the GST revenue than they would have otherwise received as a financial assistance grant. Any payments under this agreement are made based on what is referred to as the guaranteed minimum amount.[75] Payments made to ensure the minimum amount is received are included in the Commonwealth budget as budget balancing amounts. Budget balancing amounts were paid in the first two years of operation of the GST and are budgeted for 2002–2003.[76] The Commonwealth will also continue to pay the States special purpose payments (SPP).

[73] Commonwealth Budget Papers 2000–2001, Paper No 3, Chapter 1, p 5.

[74] In accordance with Part 3 of Schedule 2 of the Intergovernmental Agreement. Also note the States currently have an appointed representative as a member of the GST Rulings Panel (consisting of seven permanent members in total.) The panel consider administrative rulings on the interpretation of the GST law.

[75] Schedule 1 – Transitional Arrangements to *A New Tax System (Commonwealth-State Financial Arrangements) Act* 1999.

[76] Budget balancing assistance paid 2001–02 was $3,856.8m and a payment of $1,741.2m is budgeted for 2002–03 according to Commonwealth Budget Paper No 3, Chapter 2, p 12, 2002–03.

THE NEW NIRVANA?

The impression left from the above may be that of down-trodden State Parliaments being restrained from imposing their own income tax by a power-grabbing Commonwealth Parliament and the High Court. However the reality may be somewhat different. In a strange twist, the *Income Tax (Arrangements with the States) Act* 1978 provided the machinery for the Commonwealth to administer any State personal income tax that a State wished to impose. The States proved somewhat reluctant to take up the offer, perhaps in the belief that, in the terminology of Sir Humphrey Appleby (the mythical but consummate British civil servant of television fame), it would be a 'courageous decision' to impose a State income tax, and after some years without use the Act was repealed as otiose.

As a result of the tax reforms that Australia has implemented, some State taxes have been replaced by a transfer of GST revenue on an equalisation basis. This will result in very significant redistributive benefits to some States without a significant overall increase in total available revenue in the short term. Furthermore, while the total GST revenue is guaranteed to the States collectively, no individual State can be certain of its share. Consequently, States remain reliant upon the Commonwealth. Special purpose grants will be particularly important.

After a century of traversing the long and winding road, the States, which started the twentieth century as 'masters of their own destiny', find themselves at the end of the century as effectively almost totally beholden to the Commonwealth in terms of revenue. The Commonwealth, for practical purposes, has established a stranglehold on the two major forms of revenue raising, having effectively centralised income tax, and constitutionally having a monopoly to impose a GST. Interestingly, in the midst of all this, the Commonwealth Government has ostensibly abandoned its control over GST revenue collection and consequently a major fiscal policy tool. However, the States do not actually gain control over that revenue. All State Governments must firstly agree to any change, and then the Commonwealth must accept the decision of the States and pass the relevant legislation to effect the change, thus leaving ultimate control with the Commonwealth.

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15

Formalism and Israeli Anti-Avoidance Doctrines in the 1950s and 1960s

ASSAF LIKHOVSKI*

ABSTRACT

FOR MOST OF the twentieth century, British anti-avoidance doctrines were dominated by a formalist respect for tax-planning schemes devised by the wealthy. One explanation for this formalism was to view it as a manifestation of the desire of British judges to assist the upper classes to avoid taxation. This article examines the validity of a class-based interpretation of anti-avoidance doctrines in the Israeli context. The Israeli Income Tax Act contains a general anti-avoidance provision. However, during the first two decades after independence in 1948, Israeli courts were reluctant to use this provision and instead adopted a 'form over substance' principle. This formalism was partly the result of class-interests. But it was also created by tax administration considerations. The newly-constituted Israeli tax authorities were at first unable to deal effectively with tax evasion, let alone with tax avoidance. Judges were therefore reluctant to intervene in cases of tax avoidance, which are less clear-cut than cases of tax evasion. Class-interests, the article concludes, may sometimes be an important factor in the shaping tax doctrines, but other, more practical considerations, such as the efficiency of the tax administration machinery also play an important role.

I. INTRODUCTION

This article attempts to answer the question what factors influence the decisions of judges when they decide tax cases. It does so by looking at the history of anti-avoidance doctrines in the first decades after Israeli independence in 1948.

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Few works examine the history of tax doctrines in the Anglo-American world,[1] and the specific history of anti tax-avoidance doctrines has not been studied at all.[2] One rare exception to the general lack of interest in the history of anti-avoidance doctrines is a survey of the history of British canons of tax interpretation and anti-avoidance doctrines that is part of a wider study of the decisions of the British House of Lords written some 20 years ago by Robert Stevens.[3] Stevens' argument in this work is that two major factors influenced the decisions of the House of Lords on issues of tax avoidance: class interest and the demands of social solidarity in times of emergency.

According to Stevens' historical narrative, in the nineteenth century British courts did not treat tax matters differently from other legal matters, but by the first decade of the twentieth century, following the introduction of progressive income taxation in Britain, a formalist, pro-taxpayer stance on tax interpretation and tax avoidance came to dominate the decisions of the House of Lords. This stance enabled the wealthy to avoid taxation, and it can be attributed to the fact that the Law Lords sought to serve the interests and to protect the wealth of 'the established sections of society.'[4] The burden of taxation on the wealthy increased in the 1930s when a Labour government raised tax rates and tax avoidance schemes became more prevalent. The House of

[1] See e.g. Carolyn C. Jones, 'Split Income and Separate Spheres: Tax Law and Gender Roles in the 1940s,' *Law and History Review,* 6 (1988), 259; Marjorie E. Kornhauser, 'The Morality of Money: American Attitudes Toward Wealth and the Income Tax,' *Indiana Law Journal,* 70 (1994), 119; R. Cocks, 'Victorian Barristers, Judges and Taxation: A Study on the Expansion of Legal Work,' in G. R. Rubin and David Sugarman eds., *Law, Economy and Society in England 1750–1914* (Abingdon: Professional Books, 1984), 445; Meta Zimmeck, 'Gladstone Holds his Own: The Origins of Income Tax Relief for Life Insurance Policies,' 58 *Bulletin of the Institute of Historical Research,* (1985), 167. In recent years, American legal scholars have started to devote more attention to the political and cultural factors that shaped tax law. See e.g. Karen B. Brown & Mary Louise Fellows eds., *Taxing America* (New York: New York University Press, 1996); 'Symposium: Critical Tax Scholarship,' 76 *North Carolina Law Review* (1998). However, most of the recent work focuses on contemporary tax matters rather than on the history of taxation.

[2] There are, of course, surveys of anti-avoidance doctrines (see the articles and books cited in note 9 below) but all these works are written from point of view which assumes that law is an autonomous enterprise unaffected by non-legal considerations. Recently, the subject began to receive more theoretically-oriented attention. See generally Assaf Likhovski, 'The Duke and the Lady: *Helvering v. Gregory* and the History of Tax Avoidance Adjudication,' *Cardozo Law Review* (forthcoming).

[3] Robert Stevens, *Law and Politics: The House of Lords as a Judicial Body, 1800–1976* (Chapel Hill: University of North Carolina Press, 1978).

[4] Stevens, *Law and Politics,* pp. 170–6. See also David W. Williams, 'Taxing Statutes are Taxing Statutes: The Interpretation of Revenue Legislation,' 41 *M.L.R.* 404, 409–410 (1978); William D. Popkin, 'Judicial Anti-Avoidance Doctrine in England: A United States Perspective,' [1991] *British Tax Review* 283, 290–1 (discussing 18th and early 19th century English tax interpretation doctrines). For a history of the fiscal changes of the first decade of the 1900s, see Martin Daunton, *Trusting Leviathan: The Politics of Taxation in Britain, 1799–1914* (Cambridge: Cambridge University Press, 2001), p. 330ff.

Lords dealt with the matter in the famous *Duke of Westminster* case, in which the Lords voiced a formalist attitude to tax planning based on the notion that 'every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be.'[5]

During the Second World War, the House of Lords modified its approach. Now, some Lords adopted a 'patriotic' approach to tax avoidance according to which all citizens are 'under an obligation to pay a fair share' of their taxes.[6] One well known manifestation of this approach was the *Latilla* case.[7] However, once the war ended, the Law Lords returned to their old formalist, pro-taxpayer stance in such cases as *Vestey's Executors v IRC*.[8] Only in the beginning of the 1960s was the earlier, formalist approach to tax avoidance rejected and a new, purposive approach to tax interpretation adopted. This trend intensified in the 1980s.[9]

Despite the fact that more than twenty years have passed since the publication of Stevens' book, and despite the rather crude instrumentalist conception of law upon which it is based, his historical interpretation, as far as I know, has not yet been challenged.[10] While there are many surveys of the development of anti-avoidance doctrines in Britain and other common-law countries, all of them are concerned with the descriptive and analytical aspects of anti-avoidance doctrines rather than with the political, sociological or historical context in which these doctrines developed.[11]

In this article I would like to take Stevens' work as the starting point of my discussion. However, I will not attempt to revisit the British cases; instead, I would like to use Stevens' insights to explore the history of

[5] *Commissioners of Inland Revenue v Duke of Westminster*, [1936] A.C. 1, 19 (1935). See also Stevens, *Law and Politics,* 206–8; Ian A. Saunders, 'Recent Trends in United Kingdom Anti-Avoidance Law,' 25 *Case Western Reserve Journal of International Law* 23 (1993), note 40 (arguing that to view the decision in that case as requiring that courts prefer form to substance is a 'gross oversimplification'); John Tiley, *Revenue Law* (4th edn, Oxford, Hart, 2000), 93–4 (distinguishing between two possible understandings of the *Duke of Westminister* doctrine, one which simply states that the legal facts created by the parties should be respected and another, less-refined, understanding which 'tended to look kindly on attempts to avoid taxes').

[6] Stevens, *Law and Politics,* pp. 347, 392–3.

[7] *Latilla v Inland Revenue Commissioners,* 1943 A.C. 377, 381. See also G. S. A. Wheatcroft, 'The Attitude of the Legislature and the Courts to Tax Avoidance,' 18 *M.L.R.* 209, 218 (1955).

[8] Stevens, *Law and Politics,* p. 394. See also J. P. Hannan & A. Farnsworth, *The Principles of Income Taxation* (London: Stevens & Sons, 1952), pp. 549–54.

[9] Williams, 'Taxing Statutes,' pp. 420–22; Popkin, 'Judicial Anti-Avoidance Doctrines,' pp. 291–2; Stevens, *Law and Politics,* pp. 411–412, 599, 600–3; Tiley *Revenue Law*, pp. 105–6, 109–10. For a critique of the 'indiscriminate adoration of substance' or the 'child-like notion of substance' see John Tiley, 'Judicial Anti-Avoidance Doctrines,' [1987] *British Tax Review*, 220, 234, 244; John Tiley, 'Judicial Anti-Avoidance Doctrines,' [1988] *British Tax Review,* 108, 139.

[10] For a more recent article which basically repeats Stevens' description of the case-law (although it does not adopt his class-based interpretation), see Popkin, 'Judicial Anti-Avoidance Doctrine.'

[11] For British surveys, see e.g. Wheatcroft, 'The Attitude of the Legislature'; Edward Troup, 'Unacceptable Discretion: Countering Tax Avoidance and Preserving the Rights of the Individual,' 13 *Fiscal Studies* 128 (1992); Saunders, 'Recent Trends'; Tiley, *Revenue Law*, pp. 85–110. For American discussions of anti-avoidance doctrines, see e.g. Ralph S. Rice, 'Judicial

Israeli anti-avoidance doctrines beginning with the enactment of an Income Tax Ordinance in Palestine in 1941 and ending with the amendment of the general anti-avoidance provision of the Israeli Income Tax Act in 1968.[12]

Israeli income tax law, like the law of other British dominions and colonies, was based on and influenced by British tax law.[13] It therefore offers an opportunity to examine Stevens' arguments using comparative methodology. The fact that Israeli tax law was based on British tax law makes the comparison possible. The fact that there are major differences between British and Israeli economy, society and law makes the comparison interesting.[14]

The argument of this article is that while class-interests also played a role in shaping Israeli judicial anti-avoidance doctrines, Stevens' argument

Techniques in Combating Tax Avoidance,' 51 *Mich. L. Rev.* 1021 (1953); Marvin A. Chirelstein, 'Learned Hand's Contribution to the Law of Tax Avoidance,' 77 *Yale L. J.* 440 (1968); Alan Gunn, 'Tax Avoidance,' 76 *Mich. L. Rev.* 733 (1978); Joseph Isenberg, 'Musing on Form and Substance in Taxation,' 48 *U. Chi. L. Rev*. 859 (1982); Joshua Rosenberg, 'Tax Avoidance and Income Measurement,' 87 *Mich. L. Rev.* 365 (1988); Likhovski, 'The Duke and the Lady'.

[12] There are a number of descriptive or analytical discussions of Israeli anti-avoidance doctrines. See A. Lapidoth, *Evasion and Avoidance of Income Tax: A Comparative Study of English Law and Israeli Law* (Jerusalem: Museum of Taxes, State Revenue Administration, 1966); David Glicksberg, *Gvulot Tikhnun Ha-Mas* (Tax Planning) (Jerusalem: Hebrew University, Harry Sacher Institute for Legislative Research and Comparative Law, 1990); Arye Lapidoth, *Ekronot Mas Hakhnasa ve-Mas Rivkhey Hon* (Principles of Income and Capital Gains Tax) (Jerusalem: Tax Museum, 1970), 230–36; Aharon Yoran & Yekhezkel Flumin, *Tikhnun ha-Mas be-Haye ha-Esek* (Tax Planning) (Jerusalem: Academic Press, 1973), 15–20; Yizhak Hadari, 'Tax Avoidance in Linear Transactions: The Dilemma of Tax Systems,' 15 *U. Pa. J. Int'l Business Law* 59 (1994). Recently, a number of works examining Israeli tax law from critical, non-formalist perspectives have appeared. See Tsilly Dagan, 'Ha-Hashlachot ha-Halukatiot ha-Nistarot be-Dinei Misim' (The Hidden Distributive Aspects of Tax Law) in M. Mautner ed., *Tsedek Halukati be-Yisrael* (Distributive Justice in Israel) (Tel Aviv: Ramot, 2000), 261; Yechezkel Line, 'Ha-Medina, Elitat ha-Asakim ve-Ko' alityot: Mas ha-Bursa ke-Mashal' (The State, the Business Elite and Coalitions: The Stock Exchange Tax as a Parable) in Mautner, *Tsedek Halukati*, 223; Assaf Likhovski, 'Kategoryot shel Min u-Maamad be-Dine Mas Hakhnasa,' (Categories of Gender and Class in Income Tax Legislation) 24 *Iyune Mishpat* 205 (2000); Neta Ziv, 'Misuy ha-Mi'ut: ha-Maavak le-Bitul Mas Rekhus ke-Hakara ba-Shoni ha-Tarbuti shel Falestina'im be-Yisrael' (The Taxation of the Minority: The Struggle to Abolish Property Tax as a Recognition of the Cultural Difference of Palestinians in Israel) 26 *Iyune Mishpat* 197 (2002). None of these works deals with tax-avoidance.

[13] On anti-avoidance doctrines in other British Dominions and colonies, see e.g. Tiley, *Revenue Law,* p. 91; Edwin Harris, *Canadian Income Taxation* (Toronto: Butterworth, 4th ed., 1986), pp. 58ff.

[14] On the benefits and dangers of comparative work generally and comparative legal history in particular, see e.g. Else Øyen, 'The Imperfection of Comparisons,' in Else Øyen, *Comparative Methodology: Theory and Practice in International Social Research* (London: Sage, 1990), 1; Gunter Frankenberg 'Stranger than Paradise: Identity & Politics in Comparative Law' 1997 *Utah L. Rev*. 259; Annelise Riles, 'Wigmore's Treasure Box: Comparative Law in the Era of Information' 40 *Harv. Int'l L.J.* 221, 229, 256 (1999); Charles Donahue Jr., 'Comparative Legal History in North America' *Tijdschrift voor Rechtsgeschiedenis* 65 (1997): 1; 'Comparative Law and Legal History in the United States,' *American Journal of Comparative Law,* 46 (1998): 1; Neil Duxbury, *Jurists and Judges* (Oxford: Hart, 2001).

cannot be applied wholesale to the Israeli context because other factors also contributed to the shape of the law.[15] At least in the Israeli case, the specific scope of anti-avoidance doctrines was also determined by practical considerations such as the reluctance of the courts to intervene in tax avoidance cases at a time when the tax authorities could not deal effectively with tax evasion.

Taking the tax administration context into account in the writing of the legal history of tax doctrines can enrich our historical narrative.[16] It can also link this history to wider arguments about the factors influencing tax policy and tax law. Social scientists have offered a number of possible approaches to the study of the way tax policy and tax law are shaped. One such approach is to assume that tax policy is solely shaped by the pressure of classes or interest groups. This approach is favored by neo-Marxist scholars and by interest-group pluralists. Both groups of scholars assume that the state is not autonomous and that tax policy is merely a reflection of the interests of the social groups that dominate it. An opposite, state-centered approach argues that the state is in many respects autonomous and therefore tax law should be understood as a reflection of the interests of state actors or of institutional structures.[17] An intermediate model suggests that both state and society are fragmented and that tax policy is often shaped by coalitions composed of state actors and society-based groups working together to achieve their goals in opposition to other actors and groups within the state and in society. [18]

Somewhat similar models may be used to understand the history of judge-made law. One possibility would be to adopt an autonomous model of judicial law-making, focusing on the internal logic of the law.

[15] The subject of this article is the history of Israeli anti-avoidance doctrines but a comparison of the history of anti-avoidance doctrines in Britain and other jurisdictions may also reveal the limits of a class-based interpretation of anti-avoidance law. One example is the American case. Despite the fact that in the United States too, judges were seen as servants of the interests of the wealthy (certainly until the 1930s), American courts often adopted a non-formalist approach to issues of tax avoidance. There are a number of works that compare British and American anti-avoidance doctrines, noting the difference in approach. See e.g. Peter Millett, 'Artificial Tax Avoidance: The English and American Approach,' [1986] *British Tax Review* 321; John Tiley, 'Judicial Anti-Avoidance Doctrines,' [1987] *British Tax Review* 180, 220, 433; [1988] *British Tax Review* 63, 108; Popkin, 'Judicial Anti-Avoidance Doctrine.'

[16] See also Robert Colley, 'Mid-Victorian Employees and the Taxman: A Study in Information Gathering by the State in 1860,' 21 *Oxford Journal of Legal Studies,* 593, 596 (2001) (noting the importance of the study of the 'daily operations of laws.').

[17] For a general discussion on the role of the state, see Theda Skocpol, 'Bringing the State Back In: Strategies of Analysis in Current Research,' in Peter B. Evans, Dietrich Rueschemeyr and Theda Skocpol eds., *Bringing the State Back In* (Cambridge: Cambridge University Press, 1985), pp. 3–37; See also Sven Steinmo, *Taxation and Democracy* (New Haven: Yale University Press, 1993).

[18] For a summary see Line, 'Ha-Medina' pp. 225–230.

A second possibility would be to adopt a society-based model (this is Stevens' approach). This model would view judges as totally dependent on the interests of the group or class they come from or represent. An intermediate model would view judges as partially autonomous and partially subservient to the interests of the classes or groups they seek to serve. This last model is the one that I adopt in this article — The history of anti-avoidance doctrines in Israel, I argue, shows that the shape of the doctrines was partly influenced by the class-interests of the judges and partly shaped by legal and psychological considerations. However, tax doctrines were also shaped in response to the outcome of actions by other state institutions such as the Revenue. Only by taking into account all these factors can the specific trajectory of the development of anti-avoidance doctrines be understood.

II. ANTI-AVOIDANCE AND TAX INTERPRETATIONS DOCTRINES IN ISRAEL 1941–1968

This part of the article outlines the history of anti-avoidance and tax interpretation doctrines adopted by Israeli courts in the 1950s and 1960s. It begins with a survey of tax avoidance cases and summarise the periodical literature on tax avoidance. It then examines various approaches to the issue of tax interpretation, again looking at both the case law and periodical literature. It is often very difficult to find a single trend in the cases. Judges are notorious for using legal doctrines as rhetorical tools, often adopting logically conflicting positions in different cases and sometimes in the same case.[19] However, it is still often possible to point to trends in the cases and periodical literature, always bearing in mind the partially misleading nature of any generalisation.

1. Anti-avoidance Doctrines

1) Case Law

Income tax was first introduced in Palestine in September 1941.[20] The Palestine Income Tax Ordinance of 1941 was based on a Model Income

[19] This is one of the major insights of the realist movement. See e.g. Karl Llewellyn 'Remarks on the Theory of Appellate Decision and the Rules or Canons about how Statutes are to be Construed,' 3 *Vanderbilt Law Review* 395 (1950). For a somewhat similar discussion of the bewildering lack of any rationale in American tax-avoidance cases, see Rice, 'Judicial Techniques.'

[20] For histories of income taxation in Palestine and Israel in general, see Jacob Metzer, *The Divided Economy of Mandatory Palestine* (Cambridge: Cambridge University Press, 1998);

Tax Ordinance prepared in 1922 by a British 'Interdepartmental Committee on Income Tax in Colonies not Possessing Responsible Government.'[21] The act included several specific anti-avoidance provisions.[22] It also included a general anti-avoidance provision (GAAP) - section 22B of the Ordinance.[23] This section stated that 'where the Assessing Officer is of the opinion that any transaction which reduces or would reduce the amount of tax payable by any person is artificial or fictitious or that any disposition is not in fact given effect to, he may disregard any such transaction or disposition and the persons concerned shall be assessable accordingly.' The provision was copied from the Kenya Income Tax Ordinance of 1940. Similar provisions also existed in the income tax legislation of other British colonies and dominions such as Cyprus, Canada, Australia and South Africa. All these provisions may have originated in the English Excess Profits Duty legislation of 1915 that mentioned 'fictitious or artificial' transactions.[24]

Between 1941 and the end of the British Mandate in Palestine in May 1948, very few tax cases came before the courts.[25] None of the cases that did reach the courts dealt with the anti-avoidance provision of the Income Tax Ordinance.[26] One reason for this was the fact that the Income Tax Ordinance was new and the authorities were not keen to litigate cases

Lapidoth, *Evasion,* pp. 16–25; Arye Lapidoth, 'Trends in the Income Tax Legislation of Israel,' *Scripta Hierosolymitana: Vol. 26 - Studies in Israel Legislative Problems* (Jerusalem: Magnes Press, 1966), 325; Harold C. Wilkenfeld, *Taxes and People in Israel* (Cambridge MA: Harvard University Press, 1973), pp. 16–42; Aharon Yoran '40 Years of Tax Law,' 24 *Israel Law Review* 738 (1990); Glicksberg, *Gvulot Tikhnun ha-Mas*, pp. 20–25; Avraham Mandel ed., *Hitpatkhut ha-Misim be-Eretz Yisrael: Skira Historit* (The History of Taxation in Palestine and Israel) (Jerusalem: Tax Museum Press, 1968).

[21] See Abraham Fellman, *The Palestine Income Tax: Law and Practice* (Tel Aviv: Lapid Publishing Co., 1946), p. 27.

[22] For example, section 21A dealing with 'dispositions in favor of children'; section 22 dealing with undistributed profits of companies; section 45(2) disregarding non-genuine partnerships; and section 28(3) disregarding agreements between a non-resident and a resident which result in a reduction of ordinary profits. Some of these provisions were added or modified in 1945 and 1947. See Fellman, *Palestine Income Tax,* p. 256; S. Moses, *The 1947 Income Tax Amendments* (Tel Aviv: Bitaon, 1947). See also Lapidoth, *Evasion,* p. 156 ff. For a list of specific anti-avoidance provisions in the Israeli versions of the act, see e.g. A. Witkon, *Dine Misim: Mas Hakhnasa, 'Izavon ve-Shevach* (Introduction to Tax Law: Income, Estate and Capital Gains for Real Estate Taxes) (4th ed., Jerusalem: Schocken, 1969), p. 56.

[23] Section 22B became section 28 in the 1947 amendment to the Income Tax Ordinance, and subsequently section 86 of the 1961 Hebrew New Version of the Ordinance.

[24] See Fellman, *Palestine Income Tax*, pp. 254–6; S. Moses, *The Income Tax Ordinance of Palestine* (Tel Aviv: Bitaon, 1946), pp. 320–23; Lapidoth, *Evasion,* pp. 164–67. For an analytical discussion of various legislative methods of combating tax avoidance, see e.g. Tiley, *Revenue Law*, pp. 87–89.

[25] See Fellman, *Palestine Income Tax*, preface; Wilkenfeld, *Taxes,* p. 207.

[26] A similar situation existed in the United States. Only fifteen years after the first 20th century federal income tax law was enacted did the first tax avoidance case dealing with this act reach the Supreme Court. See Harry J. Rudick, 'The Problem of Personal Income Tax Avoidance,' 7 *Law and Contemporary Problems* 243, 245 (1940).

whose outcome was uncertain. Instead, in cases of tax avoidance, the Palestine tax authorities preferred to compromise with the taxpayer.[27] A second possible explanation for the lack of litigation in tax avoidance cases was that tax evasion was widespread and therefore the tax administrators 'had to be as liberal as possible' when confronting tax avoidance.[28] An additional reason for the lack of use of the general anti-avoidance provision was that the Revenue and lawyers of Palestine were influenced by English law and its pro-taxpayer, conservative stance on tax avoidance.[29]

The first case to mention the general anti-avoidance provision of the Income Tax Ordinance was decided in May 1952, four years after Israeli independence and eleven years after the enactment of the Income Tax Ordinance. This case, *A.B. v Assessing Officer,* concerned a building-lease. The owner of a one-story building in Tel Aviv leased the roof of the building to two builders for a period of seven years. The builders built two additional stories on the roof and sublet them receiving substantial amounts of money from the tenants. The Revenue argued that the owner should pay income tax on the income received by the builders since the owner artificially alienated that income to the builders. This argument was rejected by Judge Wittkowski (Witkon) of the Tel Aviv District Court, who later became the leading tax law specialist on the Israeli Supreme Court. In setting out what became the conventional pro-taxpayer interpretation of the term 'artificial' in the following decade, Witkon stated that an 'artificial' transaction was one which 'assumes a form that is contrary to the accepted patterns of economic life and deviates from the paths commonly adopted in order to achieve a certain economic result.' Since a building-lease is a common sort of transaction, it cannot be deemed 'artificial.'[30]

It was another five years before the second tax avoidance case reached the courts. In *Baal Bayt v Assessing Officer*, decided in 1957, the court

[27] A. Wittkowski, 'Mas Hakhnasa: Skira al Piske Din she-Yatzu be-Eretz Yisrael' (Income Tax: A Survey of Palestine Cases), 1 *Hapraklit* 120 (1943); Fellman, *Palestine Income Tax,* p. 255; Lapidoth, *Evasion*, p. 171.

[28] Hanan Cohen, '25 Shana le-Hanhagat Mas Hakhnasa ba-Aretz' (The 25th Anniversary of the Enactment of Income Tax in Palestine) 1 *Riv'on le-Inyanei Misim* [Hereafter R.I.M.], 395, 396–7 (1965/66).

[29] See e.g. Fellman, *Palestine Income Tax*, p. 255. See also Lapidoth, *Evasion*, p. 171–2 (quoting an opinion by the Attorney General of Palestine written in 1942 which stated that in order to use the section 'it is not sufficient to establish that a transaction is unusual or unbusinesslike [since] it is a fundamental principle of the Common Law that a man can dispose of his property at his own sweet will…')

[30] I.T.A. (Tel Aviv) 6/50, *A.B. v Assessing Officer*, 7 Psakim Mehoziyim (District Courts Report) [Hereafter P.M.] 347, 351. See also Lapidoth, *Evasion*, pp. 172–3. The reason that Witkon's interpretation is pro-taxpayer is that if a certain kind of transaction reduces the tax paid by the taxpayer, it will soon become common and therefore would not be considered 'artificial' in Witkon's sense of the term. See Yoran, 'Forty Years of Tax Law,' p. 748. Witkon's approach is formalist because his test of 'artificiality' only asks whether a given transaction assumes a 'form that is contrary to the accepted patterns of economic life' instead of looking at the substance of the transaction or asking whether the subjective motive of the taxpayer was tax avoidance.

discussed a 'fictitious' rather than an 'artificial' transaction. Fictitious transactions (similar to 'sham' transactions in English law)[31] were defined by the court as those transactions in which the legal facts on which the taxpayer based his case were nonexistent. This category was almost always used by the courts when dealing with transactions that took place between family members such as parents and children. The *Baal Bayt* case, the first of many such cases, was one in which a father leased a warehouse he owned to his daughters and three weeks later the daughters sublet the warehouse to a tenant receiving five times the amount of rent that they paid. Judge Loewenberg of the Tel Aviv District Court declared that the lease to the daughters was a fictitious transaction.[32] In the following years, many other 'fictitious' transactions reached the courts and all of these cases (except one) dealt with transactions between family members.[33]

While most of the cases in the late 1950s and early 1960s dealt with 'fictitious' transactions, in some cases the courts did turn to the 'artificial' clause of the general anti-avoidance provision. In 1959, two such cases reached the Jerusalem and Tel Aviv District courts. Both cases involved the supposed camouflaging of income from interest on loans. The first case was decided by the Jerusalem District Court. In this case, borrowers were required to acquire a certain number of preference shares in a lending

[31] See e.g. Tiley, 'Judicial Anti-Avoidance Doctrines: The US Alternatives,' pp. 195–7; Tiley, *Revenue Law*, p. 95.

[32] I.T.A. (Tel Aviv) 811/56 *Baal Bayt v. Assessing Officer,* 7 *Roeh ha-Heshbon* [Hereafter *R.H.*] 371 (July 1957) [affirmed C.A. 240/57 *Mikakashvili v Assessing Officer*, 12 Piske Din [Hereafter P.D.] 1485.

[33] See I.T.A. (Tel Aviv) 315/58 *Orekh Din v Assessing Officer*, 19 P.M. 271 (21/4/59) (fictitious lease of house owned by father to son) [affirmed C.A. 237/59 *Mani v Assessing Officer*, 14 P.D. 2381 (23/11/1960)]; I.T.A. (Tel Aviv) 104/58 *Baal Bayt v Assessing Officer*, 9 *R.H.* (Spring 1959) 263; I.T.A. 97/57 (Haifa) *M.F. Ba'al Pardes v Assessing Officer*, 2(5) Kovetz Piske Din (Mas Hakhnasa) (5) 232, (21/10/58) (fictitious lease of an orange grove owned by a father to his son) [affirmed C.A. 402/58 *Freund v Assessing Officer*, 14 P.D. 205 (4/2/1960)]; I.T.A. (Tel Aviv) 975/59 *Pardesan v Assessing Officer*, 3(10) Kovetz Piske Din (Mas Hakhnasa) 882 (3/4/1960) (fictitious lease of an orange grove owned by a father to his son) [affirmed C.A. 200/60 *Cohen v Assessing Officer Kfar Sava*, 14 P.D. 1927 (16/10/1960)]; C.A. 470/59 *Ram v Assessing Officer*, 14 P.D. 811 (11/5/1960); I.T.A. (Tel Aviv) 6/60 *P.R. v Assessing Officer*, 11 *R.H.* 286 (May–June 1961) affirmed C.A. 356/61 *Rosenfeld v Assessing Officer*, 16 P.D. 715 (22/3/1962)]; I.T.A. (Tel Aviv) 494/62/6 *A.R. v Assessing Officer*, 40 P.M. 249 (father transferring plot of land to daughter who subsequently sells it); I.T.A. (Tel Aviv) 371/63 *A.L. v Assessing Officer*, 14 *R.H.* 383 (Sept.–Oct. 1964) (fictitious lease of orchard partly owned by father to his son) [affirmed C.A. 353/64 *Lubovsky v Assessing Officer*, 19(1) P.D. 194]; C.A. 611/66 *Assessing Officer v Eldor*, 21(1) P.D. 421 (9/4/1967) (disposition which was not in fact given effect to); I.T.A. (Tel Aviv) 463/66 *Birenbaum v Assessing Officer* (10/5/1967) 5 (5) Piske Din Ezrahiym [Hereafter P.D.E.] (using the special anti-avoidance provision dealing with disposition in favor of children); I.T.A. (Tel Aviv) 11/67 *Kimmel v Assessing Officer*, 1 P.D.E. 69 (5/11/1967) (the sale of goodwill as a fictitious sale). See also I.T.A. (Tel Aviv) 103/58 *Y.L. v Assessing Officer*, 2(5) P.D.E. 208 (8/6/1958) (a partnership between a father and a son that was deemed genuine). See generally, Lapidoth, *Evasion*, pp. 179–82.

company in proportion to the amount of the loan. These shares were denied voting rights. They could also be denied a right to dividends and to the property of the company in cases of voluntary wind-up. The Revenue asserted that the selling of the preferred shares was an artificial transaction designed to camouflage the payment of interest that otherwise would have been taxed as income. However, the Jerusalem District Court judge who heard the case rejected the Revenue's position asserting that the creation of such preference shares was a common practice.[34]

The second case, decided by the Tel Aviv District Court six months later, was based on similar facts. It dealt with a company belonging to the General Federation of Labor, the Histadrut, which lent money on interest to agricultural collectives. Borrowers received ordinary shares of the company. They were required to purchase the shares at twice their nominal value. The Revenue claimed that the shares were worth less than their nominal value and that the premium paid by the borrowers was in fact camouflaged interest. Judge Loewenberg accepted the Revenue's position. He declared that the formalist approach of the British case-law embodied in the *Duke of Westminster* decision should not be adopted as the law in Israel since British, unlike Israeli legislation, had no general anti-avoidance provision. He also noted that even in Britain, the formalist *Duke of Westminster* position was subsequently questioned (referring to the *Latilla* decision). Finally he argued that it would be preferable to adopt the American approach which allowed the Revenue to examine the substance of the transaction rather than its form.

Loewenberg was, of course, aware that previous decisions adopted a more formalist stance. He noted Witkon's definition of 'artificiality' in the *A.B.* case and argued that the requirement that the transaction be uncommon in order to be deemed artificial would limit the power of the courts to declare common transactions artificial. Instead, Judge Loewenberg suggested that the proper understanding of the term 'artificial' was to ask whether the legal form which the parties to the transaction chose 'leads them to their economic goal in a direct, acceptable and correct way economically or whether the form indicates that the parties chose an indirect and tortuous way which does not reflect the regular patterns of economic life.'[35]

On appeal, however, Loewenberg's decision was overturned. Justice Witkon, who by now was serving on the Israeli Supreme Court, rejected

[34] I.T.A. (Jerusalem) 25/58 *Ploni v Assessing Officer*, 19 P.M. 345 [affirmed C.A. 102/59 *Assessing Officer v Ismar Trading and Investment Company*, 14 P.D. 2165 (20/10/1960)]. See also Lapidot, *Evasion*, pp. 173–5.

[35] I.T.A. (Tel Aviv) 713/58 *Hevra Plonit v Assessing Officer*, 21 P.M. 334, 339–345, 349. Loewenberg repeated his holding in I.T.A. (Tel Aviv) 432/60 *Merkaz v Assessing Officer*, 27 P.M. 135, 142 (26/12/1960).

Loewenberg's arguments and declared that the transaction was not artificial.[36] Following this decision, the chastised Loewenberg recanted. Soon a similar case came before him. This time Judge Loewenberg, citing both the *Duke of Westminster* and the Supreme Court decision overturning his previous decision, decided against the Revenue.[37]

In the early and middle 1960s, there were a number of additional cases in which the courts adopted a pro-taxpayer position.[38] One example was the *Worok* case, decided in 1965. The issue here was whether shareholders who received an interest-free loan for an unlimited period of time from their company should be taxed. Based on English and Australian precedents, Judge Loewenberg ruled that these loans were camouflaged dividends, only to have his position overturned again by the Supreme Court.[39]

In another case, in early 1966, Justice Witkon had a chance to repeat his formalist pro-taxpayer stance. This case involved a clause in the Capital Gains from Real Estate Tax that exempted apartments whose size was less than 70 square meters (without balconies) from the tax. The specific apartment in question in this case was originally larger than 70 square meters but the taxpayer turned parts of two rooms into balconies, thereby diminishing its size to 69 square meters. The Revenue claimed that this act proved his intention to avoid the tax. Witkon

[36] C.A. 421/59 *Nir v Assessing Officer*, 15 P.D. 379, 382 (24/2/1961). See also Lapidoth, *Evasion*, pp. 175–6. In his decision Justice Witkon noted that the company in question was quasi-public and therefore when it initiated the share buying-scheme, it (unlike ordinary companies) took into consideration non-economic factors such as the desire to have as many shareholders as possible.

[37] I.T.A. 607/61/6 (Tel Aviv) *Halvaah ve-Khisakhon v Assessing Officer*, 33 P.M. 412, 414. This was a case of a cooperative banking society that asked each borrower to pay an additional 1.5% of the amount of the loan as a contribution to a 'building fund' to finance the building of offices for the cooperative. The Revenue argued that this amount was camouflaged interest.

[38] C.A. 34/61 *Vaadya v Director of Capital Gains from Real Estate Tax*, 15 P.D. 2255 (29/11/1961) (Justice Silberg declaring that a 999-year lease was not to be considered a 'sale' subject to the Capital Gains from Real Estate tax, since in such matters 'one does not follow the economic substance of the transaction but only its formal shape); C.A. 373/63 *Director of Capital Gains from Real Estate Tax v Engleblatt* 17 P.D. 2978, 2980 (4/12/1960) (Silberg adopting a pro-taxpayer, anti-formalist position); I.T.A. (Tel Aviv) 215/63 *Lansil Ltd. (voluntarily windup) v Assessing Officer*, 12 P.D.E. 129 [affirmed C.A. 330/64 *Assessing Officer v Lansil Ltd*. 19(1) P.D. 211] (a company which leased its machinery for a limited period of time was subsequently voluntarily wound up and following the winding up declaration, sold its machinery to those who leased it. The capital gains provisions of the Income Tax Act exempted the sale of assets after winding up from capital gains tax, but Loewenberg, citing the *Duke of Westminster* case, concluded that he could not disregard the transaction). But see I.T.A. (Tel Aviv) 431/63/6 *Frenkel v Assessing Officer*, 41 P.M. 77 (payment classified by parties as goodwill is in fact rent. Loewenberg, ignoring the name given to the transaction by the parties based his decision on English precedents).

[39] I.T.A. (Tel Aviv) 1072/63 *Worok v Assessing Officer*, 16 R.H. 75 (Jan–Feb 1966); C.A. 416/65 *Worok v Assessing Officer*, 20 P.D. 351. See also C.A. 310/62, *Assessing Officer v Ron*, 16 P.D, 2751 (16/12/1962).

rejected this argument. 'There is no point in seeking the true intentions of the respondents in making changes in their apartment,' he said. 'It is an illusion to assume that the citizen is not aware of the fiscal consequences of his acts and omissions, and to demand that he be naive. In this way we will only educate him to be a hypocrite. It is better that the fiscal legislator not use clauses that invite the citizen to change his usual habits and follow other ways, which are undesirable socially. The draftsman who wrote section 49(b)(2) [of the Capital Gains from Real Estate Tax Law which exempted small apartments] did not, it seems, learn the lesson of the English 'window tax' of 1695 which led to the building of airless and dark buildings .... There is no 'artificiality' in the fact that the potential taxpayer plans his actions in a way which leads to an apartment-size which the law requires, and if the law is deficient, it is the role of the legislator to correct it.'[40]

Thus, until 1966, most of the cases decided by the courts adopted a formalist pro-taxpayer position. The years 1966–7 saw a shift in the case-law. The shift began in the summer of 1966 with two cases involving accountants who transferred their business to a company and became its employees. In both cases the Revenue claimed that this was an artificial transaction and in both cases the argument was accepted by the courts, based mainly on the fact that the law regulating the accountancy profession did not allow accountants to transfer their clients to someone who was not an accountant.[41]

One year later, in November 1967, the definition of the term 'artificial' that Justice Witkon first proposed in 1952 in the *A.B.* case, was replaced by a new definition. This was done in *Mefi*,[42] a case involving the purchase of a company in order to offset its losses against income made by

[40] C.A. 262/65 *Director of Capital Gains from Real Estate Tax v Tamir*, 20(1) P.D. 695, 700. Additional pro-taxpayer decisions are I.T.A. (Tel Aviv) 872/66 *Roshgold v Assessing Officer* 5(5–6) P.D.E. 53 (27/12/1966) (taxpayer established a company which owned his house in order to avoid estate tax, Judge Loewenberg argued that this is a common practice) (27/12/1966); I.T.A. (Tel Aviv) 759/66 *Pirsum ve-Sherutim Ltd. v Assessing Officer*, 5 (5–6) P.D.E. (3/5/1967) (deductions of payment of franchise made by a daughter to a parent company are not fictitious or artificial) (Loewenberg) [affirmed C.A. 338/67 *Assessing Officer v Pirsum ve-Sherutim Ltd.*, 1 P.D.E. 55 (Witkon) (23/10/67)].

[41] See I.T.A. (Tel Aviv) 1065/65 *Liway v Assessing Officer*, 52 P.M. 295 (5/6/1966) (Judge Evenur); I.T.A. (Tel Aviv) 931/65 *Swirski v Assessing Officer* 52 P.M. 365 (Judge Loewenberg) (26/7/1966). The appeals are C.A. 378/66 *Liway v Assessing Officer*, 20(4) P.D.739 (20/12/1966); C.A. 560/66 *Swirski v Assessing Officer* 21(1) P.D. 533.

[42] C.A. 265/67 *Mefi Ltd. v Assessing Officer*, 21(2) P.D. 593. The lower court decision, I.T.A. (Tel Aviv) 957/66 *Mefi Ltd. v Assessing Office*r, decided in March 1967 by judge Loewenberg, can be found in the Supreme Court File at the Israel State Archive. For an analysis of this case, see e.g. Amnon Rafael, '*Had Gadya Capitalistit: Tamrur Derekh be-Parshanut Sa'if 86 le-Pkudat Mas Hakhnasa*' (A Capitalistic 'Had Gadya' – A Signpost in the Interpretation of Article 86 of the Income Tax Ordinance) 24 *Hapraklit* 160 (1967/8).

the purchasers. Justice Silberg wrote the leading opinion in the case.[43] He argued that Witkon's definition of the term 'artificial' as anything that is 'uncommon' would make it impossible to disregard many transactions because once a transaction is profitable economically, it would immediately become common. Therefore he proposed a new, substantive, purpose-oriented, notion of 'artificiality.' The question that should be asked, he said, was whether the transaction has any substance apart from its tax consequences.

In his concurring opinion, Justice Witkon reversed his earlier position. He noted that as a matter of policy it was perhaps desirable to encourage takeovers of loss making companies. In the past, he said, 'I always saw a danger in the fact that such a provision might teach the citizen to act hypocritically. If he only found a serious motive for his action, besides the motive of tax reduction, the section would not apply. Often a transaction will have several motives and we cannot examine the heart of the taxpayer to find out what the major motive was. Here however, the lower court found that there was no motive except tax reduction .... One cannot therefore say that the assessing officer was mistaken when he viewed the transaction as artificial.' Thus Witkon too finally came to adopt a business-purpose, anti-formalist test.[44]

2) Periodical Literature

The year 1967 marked a shift in the case-law dealing with tax avoidance. A similar shift appeared earlier in the periodical literature. There were no articles on the issue of tax avoidance in the Israeli periodicals of the 1950s, but beginning in the middle 1960s, the issue started to receive more attention.

[43] Silberg, who was an expert on Jewish law, devoted much of his opinion to a survey of Jewish law on the question. Perhaps he was influenced by an article published in the summer of 1967 in the accountants' journal on the subject of tax evasion (although there is no explicit indication of such an influence in the decision itself). See Ya'acov Bazak, '*Hishtatfut ve-Hishtamtut me-Tashlum Misim ba-Mekorot*' (Participation and Evasion of Taxes in Jewish Sources) 17 *R.H.* 372 (1967).

[44] *Mefi*, p. 603. Neither the parties nor the judges made use of the new Israeli literature on tax avoidance which began appearing in the mid 1960s (perhaps because they were unaware of it). The main argument of the parties in both the district court and the Supreme Court centered on whether buying a loss-making company is a 'common' transaction (echoing the test suggested by Witkon in the *A.B.* case). Mefi's lawyers argued, based on English and Australian texts, that such transactions are indeed common, and the Revenue and Judge Loewenberg of the district court argued that the foreign examples were inapplicable to Israel. See Israel State Archive, Jerusalem, Court file, C.A. 265/67.

In early 1964, the journal of the Israeli Accountants Association, *Roeh ha-Heshbon,* published an article entitled 'Estate Planning (Fiscal Variations on a Sad Theme).'[45] Two months later, a daily newspaper, the *Jerusalem Post*, published another article whose subtitle was 'How Businessmen Avoid Paying (Legally)'.[46] A year later, it published another article on the subject, entitled 'Tax Avoidance and Tax Evasion.'[47] A major boost to the new interest in the subject was the publication in 1966 of a book on tax avoidance by Arye Lapidoth, a former legal adviser to the Income Tax Department and the director of Fiscal Legislation at the Israeli Ministry of Justice. The book was based on a Ph.D. dissertation submitted to G.S.A. Wheatcroft of the University of London and it was published by the new Museum of Taxes established in Jerusalem by the Revenue.

The book seems to have awakened the interest of Israeli tax practitioners in the matter and, as was to be expected, much of the reaction was formalist. The conflict between the anti-formalist attitude of the officials of the State and the formalist conceptions of the accountancy profession became clear when, in the end of 1966, the Accountants Association held a special symposium on tax planning.[48] In his talk on that occasion, Lapidoth argued that in the future the courts would be more willing to intervene in the tax avoidance cases.[49] The Revenue Commissioner who also gave a talk on that occasion, implored his audience to restrain their clients. 'I cannot demand total abstinence from tax-planning but it is incumbent on all of us to attempt to restrain the phenomenon, to reduce it to reasonable aesthetic dimensions' he said, noting that 'tax avoidance opportunities are not distributed equally, because the ability to purchase

[45] Gyora Amir, 'Tikhnun Izavon: Vari'atzyot Fiskaliot al Nos'e' Atzuv' (Estate Planning: Fiscal Variations on a Sad Theme) 14 *R.H.* 7 (January–February 1964). Note that the term used in this article is the morally positive term 'tax planning' and not the term 'tax avoidance.' There is an interesting linguistic aspect to the history of tax avoidance in Israel. The term usually used by judges and scholars in the 1950s and 1960s was the morally neutral 'himan'ut mi-Mas' (tax avoidance). In the periodical literature of Israeli Accountants in the 1960s, one often encountered the morally positive term 'tikhnun mas' (tax planning) while in the *Mefi* case and in the periodical literature of the 1960s and 1970s, one finds the representatives of the State using a morally negative term 'ha'aramat mas' (tax fraud). See A. Lapidot, 'Nekudat Reut ha-Rashut ha-Mekhokeket ve-Harashut ha-Shofetet' ([Tax Planning Symposium]: The Point of View of the Legislative and Judicial Branch) 17 R.H. 56 (November–December 1966); *Mefi*, p. 595; Arye Lapidoth, 'Al Nisu'akh Huke Mas ve-'al Parshanutam' (On the Drafting and Interpretation of Tax Statutes) 8 R.I.M. 177, 179 (1976).

[46] David Krivine, 'The Higher the Tax, the Harder it is to Collect: How Businessmen Avoid Paying (Legally),' *Jerusalem Post* [Hereafter J.P.] 30/4/1964.

[47] A. W. Klimowski, 'Himanut me-Mas ve-Hishtamtut me-Mas' (Tax Avoidance and Tax Evasion) 15 *R.H.* 18 (January–February 1965) (a brief summary of Israeli, British and American law on the difference between tax avoidance and evasion).

[48] 17 *R.H.* (November–December 1966).

[49] Lapidot, 'Nekudat Reut ha-Rashut ha-Mekhokeket,' p. 63; See also Lapidoth, *Evasion*, pp. 183, 186 (noting that until 1966 the courts did not often use the general anti-avoidance provision).

the complicated advice and planning [needed] are not equally open to everyone.'[50] This, of course, earned him the ire of many of the accountants present at the symposium who argued that they must serve their clients and stick to the form of the transactions they are reporting.[51]

The first issues of the journal of the Israeli Revenue service, the *Quarterly Tax Journal*, published in 1966, also devoted much attention to the subject of tax-avoidance. The *Journal* published an article by Judge Loewenberg on tax interpretation. In it, Loewenberg adopted a conservative stance noting that 'the power of the government is great and therefore it is its duty to use its power in the most careful and balanced way .... In Britain itself [the Revenue] ... does not have a general power to ignore the form of a transaction as if it did not exist and to penetrate into its so called "actual substance".'[52]

A similar formalist attitude can be found in a book review written by Justice Witkon and published in the same volume of the *Quarterly Tax Journal*. Witkon was one of the most anti-formalist Justices among the founding generation of Israeli lawyers. In his book review, he therefore noted that one could not study the issue of tax-avoidance 'unless we view it simultaneously as a legal, sociological and psychological problem.'[53] However, in the same book review, he adopted what he called a 'realistic' position on tax avoidance, by which he meant a desire to limit the use of the general anti-avoidance provision. Witkon argued that 'when we come to solve tax problems, there is no place for emotions and moral preaching.

[50] Y. Tamir, '"Emdat ha-Rashut ha-Mevatza at: Sherutey ha-Misim' (The Position of the Executive: The Revenue) 17 *R.H.* 76, 83, 84 (November–December 1966).
[51] 'Al Medukhat ha-"Tax Planning": Me-Teguvot Haverim le-Divrey ha-Natziv' (On the issue of Tax Planning: Members Respond to the Revenue Commissioner's Speech) 17 *R.H.* 86 (November–December 1966) ('No person has a monopoly on justice and morality ... even in the State of Israel, it is no longer considered improper to earn money .... Ideologically there is no equality in a liberal society because there is compensation for education, initiative, etc.' (Y. Shemer, p. 90); 'The accountant in most cases sticks to form and not substance, unlike the Revenue which can ignore form. The accountant cannot go into the details and ask what the parties meant when they acted one way or another' (Y. Strauss, p. 91); 'Just as the citizen can plan his acts so as to avoid indirect taxation (for example by not consuming fuel or not importing foreign merchandise in order not to pay tariffs), he can do whatever he can, within the legal framework, in order to avoid direct taxation. Justice and equity should inspire the legislator but one cannot demand that the citizen should put his conscience above the law itself and he must treat the law like any other economic consideration' (D. Porat, p. 93); 'When the commissioner touches on the moral aspect of the taxpayers' behavior and views avoidance as immoral, this is controversial...; furthermore, he attacks the accountants and implies that they are also involved in the matter. We must protest and prove him wrong .... [If there are loopholes in the law], it is not immoral on the part of the taxpayer and tax planner to use them' (M. Lazar, p. 95).).
[52] H. Loewenberg, 'Perush Hukim Fiskaliym, Tokh Simat Lev Meyukhedet la-Tzura ve-la-Tokhen: Ma'amar Sheni' (The Interpretation of Fiscal Legislation with an Emphasis on Form and Substance: Part II) 1 *R.I.M.* 401, 406–7 (1965/6).
[53] A. Witkon, 'Al Hitkhamkut ve-Himanut mi-Mas Hakhnasa,' (Book Review: Tax Avoidance and Tax Evasion), 1 *R.I.M.* 523, 527 (1965/6).

We should not don the mantle of saints and fulminate against the citizen who knows how to minimize his tax, and we should not 'pity' the little man who is innocently caught in the tax web.' How did Witkon justify his position? One argument he used was practical. He said that general anti-avoidance provisions are futile because they are based on the assumption that the judges know what the normal and natural behavior is, that such transactions do not follow.[54] A second argument was based on the separation of powers. The power to decide which transactions are normal and which are 'artificial' is in fact a legislative matter and it is wrong to leave it to the judges. Finally, Witkon used a political argument based on the notion of discrimination. He noted that there are many forms of tax avoidance, some of which are legal. For example, there are 'benefits that certain kinds of employees and the self-employed enjoy and which undermine fiscal morality in a far more serious way [than tax avoidance] but these benefits are backed by powerful pressure groups and the authorities cannot touch them.'[55]

3. Legislation

The debate in the case-law and the periodical literature of the mid-1960s on the issue of tax-avoidance finally led to legislative reform in 1968. In March 1968, the Government submitted a bill amending various sections of the Income Tax Ordinance. One of the amendments called for the addition of a new clause to the general anti-avoidance provision. Until then, the provision had dealt with 'artificial' and 'fictitious' transactions or with 'any disposition not in fact given effect to.' The new law added a fourth clause dealing with transactions 'whose principle object is to reduce tax'.[56]

[54] *Ibid.*, 525–6.
[55] *Ibid.*, 526–7. There were additional articles in the following years in which the 'form over substance' principle was reiterated. Dov Neiger, 'Ekron Haramat ha-Masach be-Mas Hakhnasa' (Piercing the Company Veil in Income Tax Law) 2 *R.I.M* 127 (1967/8). A. W. Klimowsky, 'Asakot Melakhutyiot O Beduyot' (Artificial or Fictitious Transactions) 18 *R.H.* 369 (1968); Yoran & Flumin, *Thiknun ha-Mas*, 15 ('a fundamental rule is that the taxpayer can plan his business and actions within the law so that his taxes will be as low as possible').
[56] Hok le-Tikun Pkudat Mas Hachnasa (no. 13), 1968, *Hatsaot Hok*, 176, 179 (1968). It should be noted that such a provision was already envisioned by the British government of Palestine in the 1940s when it proposed amending the general anti-avoidance provision of the Income Tax Ordinance (section 22B) by adding the words '... or where the Assessing Officer is of opinion that the main purpose for which any transaction was effected was the avoidance or reduction of tax.' The explanation for the amendment was that it was designed to make the section 'more effective,' since there were cases in which the motive of tax avoidance was clear but there was a problem in providing evidence that the transaction was indeed fictitious or artificial. However, the proposed amendment was not added to the section in the final draft of the law. See Lapidoth, *Evasion*, pp. 169–70. See also Boaz Nahir, "Iska Melakhutit' (The Artificial Transaction) 3 *R.I.M.* 211 (1968). For the English precedents (Excess Profits Tax of 1941), see Wheatcroft, 'The Attitude of the Legislature,' p. 223.

The proposed amendment was meant to clarify the power of the Revenue, following the decision in *Mefi*.[57] There was some opposition to the amendment from right wing parties in the Israeli parliament (Knesset) who argued that 'everybody is entitled to run his business ... as he deems fit' and complained that small businessmen were already suffocating under the tax burden.[58] The Knesset slightly amended the bill changing the wording from 'whose principle object' to 'one of whose principle objects is ... the improper reduction of tax' (apparently in order to distinguish between tax avoidance transactions and other transactions which do lead to the reduction of tax but that are viewed favorably by the state such as mergers).[59] This did not satisfy the opposition. MK Shmuel Tamir, a lawyer, argued that the use of the term 'improper' would lead to uncertainty, which would be detrimental to businessmen. If the proposed amendment were enacted, he warned, the middle classes would flee Israel and immigrants from the West would not come.[60]

Like Lapidoth's 1966 book, the amendment was not received kindly by tax practitioners. Boaz Nahir, the lawyer who represented the taxpayer in *Mefi*, published an article in the *Quarterly Tax Journal* criticizing the discretion given to the Revenue. It would lead to 'friction between the assessing officer and the taxpayer' and to 'economic uncertainty'. The way to fight tax avoidance, Nahir argued, was by lowering tax rates and by abolishing distinctions between various types of income, some exempt from the tax and others not.[61] Witkon too published an article in 1969 questioning the wisdom of the amendment. In his article he noted that the general anti-avoidance provision 'posed a difficult problem of interpretation' because it did not provide any conceptual criteria for deciding which transactions could be ignored. Instead, it required the judge to make value judgments and use 'moral and good citizenship' criteria. The legislator, he complained, did not choose 'clear and defined intellectual concepts but moral and emotional values' as the basis for the provision, thus leading to 'subjectivism'.[62] Another article, published by an accountant, Y. Stern, in

[57] 51 Divre ha-Knesset [Hereafter D.K.] 2017 (27/5/1968) (Z. Dinstein, Deputy Finance Minister).

[58] 51 D.K. 1800–1801 (7/5/1968) (Aharon Goldstein, GHL); 51 D.K. 1970 (Shmuel Tamir, Ha-Merkaz ha-Hofshi); 51 D.K. 1974 (Uri Avneri, Ha-Olam ha-Ze; 51 D.K. 1987 (Mordechai H. Stern, GHL).

[59] 52 D.K. 2995 (31/7/1968). See also Daniel Shakhnai, 'Ha-Tikunim be-Pekudat Mas Hakhnasa: He'arot ve-He'arot' (Notes on the Amendments to the Income Tax Ordinance) 3 *R.I.M.* 226, 233–4 (1968).

[60] 52 D.K. 2999 (31/7/1968).

[61] Boaz Nahir, "Iska Melakhutit' (The Artificial Transaction) 3 *R.I.M.* 211, 213 (1968); Boaz Nahir, 'Ve-Od 'Al 'Iska Melakhutit' (Further Observations on the Artificial Transaction) 4 *R.I.M.* 31, 34 (1969).

[62] A. Witkon, 'The Problem of Interpretation in Tax Law,' 6 *R.I.M.* 9, 11–13 (1971).

Roeh ha-Heshbon, the accountants' journal, also criticised the new amendment for giving the assessing officer more discretion thus leading to more litigation.[63] Practically speaking, however, the fears of the opponents of the amendment proved unfounded. The Revenue and the courts did not use the new addition to the general anti-avoidance provision except in one case, in which the court expressed its frustration at the need to define what an 'improper reduction of tax' really meant.[64]

Perhaps it is best to end the story of the emergence of tax avoidance as a major issue in Israeli case-law, literature and legislation in the 1960s by examining the way the issue appeared on the pages of the journal of the Accountants Association – *Roeh ha-Heshbon.* As I noted before, in the 1950s, tax avoidance was not mentioned in articles published in this or any other professional journal. However, by the late 1960s, it became a central (and respectable) concern. This was manifested in the fact that in 1969, the journal inaugurated a special section devoted 'Tax Planning.'[65]

2. Tax Interpretation

Issues of tax-avoidance are intimately connected with issues of tax interpretation.[66] However, while it is relatively easy to point to a trend in the development of tax avoidance doctrines in the case law of the 1950s and 1960s, it is more difficult to find a similar trend in the cases dealing with tax interpretation. Karl Llewellyn long ago noted that canons of interpretation often conflict with each other and that judges can use them as tools to justify any result they desire.[67] It seems that such a description is also applicable to the history of canons of tax interpretation in early Israeli case law: Israeli judges used the canons at their convenience, alternating between a pro-taxpayer and a pro-state position.

[63] Y. Stern, 'Himanut mi-Mas ve-Hafkhatat Mas: Al ha-Tikun le-Seif 86 bi-Fkudat Mas Hakhnasa,' (Improper Tax Avoidance and tax minimisation: On the Amendment of Section 86 of the Income Tax Ordinance), 18 *R.H.* 494 (1968).

[64] See C.A. 823/75 *Hercikovitz v. Assessing Officer,* 30 (3) P.D. 163 (1976).

[65] The section was called 'Eshnav le-Tikhnun ha-Khavut be-Mas' (A Window to Tax Planning). See e.g. N. Fridax, 'Tax Planning: No 1: Estate Planning,' 19 *R.H.* 400 (1969). The growing interest in tax planning was also manifested in the fact that in 1973 the first book devoted to tax planning was published. It was written by an accountant and a tax-law professor at the Hebrew University. See Yoran and Flumin, *Tikhnun ha-Mas*. Thus in the early 1970s, tax planning emerged as a respectable sub-field of the legal and accounting profession.

[66] See e.g. Lapidoth, *Evasion*, p. 147 (arguing that 'avoidance is more readily permitted where strict construction is applied as happens both in England and in Israel').

[67] See Llewellyn, 'Remarks on the Theory of Appellate Decision.'; On various tax interpretation canons, see e.g. A. Witkon, 'Darkhe Parshanut be-Tkhum Dine ha-Misim' (Methods of Interpretation in Tax Law) in D. Friedmann & Y. Shiloah eds., *Sefer Loewenberg* (In Memoriam Judge H.S. Loewenberg) (Tel Aviv, 1988), pp. 13, 14.

During the British Mandate, judges often adopted a pro-taxpayer attitude to tax interpretation.[68] Soon after the establishment of the State of Israel, however, different justices on the Israeli Supreme Court offered conflicting approaches to the issue. Thus in a case decided in 1950, Justice Agranat stated that tax laws should not be interpreted strictly. When the law's purpose is evident, Agranat said, its language can be given the broadest meaning. This, he argued, fits the 'modern approach' which strives to uphold the intention of the legislator even if he used inexact language.[69] On the other hand, Justice Cheshin declared in another decision, given only ten weeks later, that 'tax legislation should be constructed in the narrowest way possible and the citizen should not be burdened by taxes unless the language of the law is clear and unambiguous.'[70]

Other cases in the 1950s and early 1960s also show that the court could sometimes adopt a pro-taxpayer and sometimes an anti-taxpayer stance. In some cases the justices argued that 'one cannot ask the citizen to pay a tax unless there is a clear base in the law which cannot be interpreted in more than one way,'[71] or argued that when there is doubt about the correct interpretation of a tax statute, one must chose the interpretation which is in favor of the taxpayer.[72] In other cases, however, the justices rejected the argument that tax law should be interpreted in favour of the taxpayer,[73] and stated 'the court must find the legislators' intention and only if it cannot do so … then it will use strict construction which favors the taxpayer. … There is no big difference between the canons of construction which apply to fiscal laws and the rules which guide us in the interpretation of other laws. The claim that fiscal laws will always be interpreted in favor of the taxpayer is exaggerated and we should use it carefully.'[74]

2) *Periodical Literature*

Like the case-law of the 1950s and 1960s, the periodical literature of the period did not contain a uniform approach to the issue of tax interpretation.

[68] See e.g. I.T.A. 2/44 *Gesundheit v Assessing Officer, Tel Aviv*, (1944) P.L.R 265.
[69] H.C. 69/49 *Rosen v Registrar of Tel Aviv District Court*, 5 Psakim 217, 222–3.
[70] H.C. 34/50 *Asnin v Municipality of Afula*, 4 P.D. 898, 911. See also A.V. Klimowsky, 'Perush Hukey Misim' (The Interpretation of Tax Legislation) 2 *R.H.* 181 (1951/2); A. V. Klimowsky, 'Hukey Misim ve-Nitzulam' (The Utilization of Tax Legislation) 3 *R.H.* 61 (1952/3).
[71] H.C. 107/58 *Avne Leshem v Custom Collector*, 38 Psakim 208, 213.
[72] C.A. 401/64 *Municipality of Tel Aviv-Jaffa v 'Teper Brothers'* 19 P.D. 175 (28.1.1965).
[73] C.A. 120/52 D. *Komropsky v Director of Capital Gains from Real Estate Tax*, 7 P.D. 141, 153. See also C.A. 259/61 *Assessing Officer v Alman* 16 P.D. 1808 (13/9/1961); C.A. 31/63 *Feldberg v Director of Capital Gains from Real Estate Tax*, 17 P.D. 1231 (16/6/1963).
[74] C.A. 39/61 *Hamashbir v Director of War Damage Compensation Fund*, 15 P.D. 1765, 1769 (17/8/1961).

One can identify three basic approaches to the issue, which, not surprisingly, fit the professional identity of the writers on the subject. The first approach was to ignore the pro-taxpayer British canons and adopt a pro-Revenue stance. This position can be found in a 1953 article published in the newsletter of the Revenue, which mentioned four general methods of interpretation of statutes : literal, logical, historical and systematic. The article failed to mention the fact that according to British law, tax statutes were supposed to be constructed strictly or in favour of the taxpayer.[75]

The second position was the adoption of a pro-taxpayer approach. Thus an article published in the Bar Association Journal in 1964, insisted that in cases of doubt, fiscal laws should be interpreted in favor of the taxpayer.[76] In another article published in 1965, Judge Loewenberg stated that 'in fiscal matters the great rule is that [the state] cannot tax the citizen unless there is a law which is unambiguous'.[77] Loewenberg then admitted that there is confusion in the cases. Some cases do not follow this rule, but he concluded his article by upholding the principle of the 'sanctity of the form' stating that 'in conclusion, it is possible to say as the people of Israel said about the new moon: 'thus you shall do and sanctify'; that is, the letter of the law is binding first and foremost. Only when it is unclear can it be interpreted. One can disregard transactions by taxpayers, but here, too, the duty is to preserve the sanctity of the form as long as it is not fictitious or artificial. The desire to 'do justice' cannot overcome this.'[78]

There was also a third position in the literature, which can be described as a intermediate position, between the pro-Revenue and the pro-taxpayer approaches. This position was voiced by Justice Witkon, who advocated a strict construction approach, but one that would often lead to pro-Revenue decisions. Thus as early as 1954, Witkon stated that the 'prevailing (and wrong) attitude is that tax law should be always interpreted in favor of the taxpayer just as criminal law should be interpreted as much as possible in favor of the accused. However ... the correct rule is that every fiscal

[75] Dr. Sigmund Pnikal, 'Ha'im 'al Pakid ha-Oved be-Agaf Mas Hakhnasa Lada'at et Huke ha-Medina?' (Should Revenue Employees Know the Laws of the State?) *Yedion Pnimi-Agaf Mas Hakhnasa*, [Hereafter Y.P.] 40, 51–2 (December 1953).
[76] Yaacov Quat, 'Hakhnasa "Ra'ayonit" O Dimyonit?' (Notional or Imaginary Income?) 20 *Ha-Praklit* 315, 317 (1964).
[77] H. Loewenberg, 'Perush Hukim Fiskalim, Toch Simat Lev Meyukhedet Latzura ve-Latochen' (The Interpretation of Fiscal Legislation with an Emphasis on Form and Substance: Part I) 1 *R.I.M.* 268, 271–2 (1965/6).
[78] H. Loewenberg, 'Perush Hukim Fiskaliym, Tokh Simat Lev Meyukhedet la-Tzura ve-la-Tokhen: Ma'amar Sheni' (The Interpretation of Fiscal Legislation with an Emphasis on Form and Substance: Part II) 1 *R.I.M.* 401, 409 (1965/6).

law should be interpreted strictly.'[79] This formula was often repeated in subsequent articles.[80]

Just as one can sense a shift in the development of anti-avoidance doctrines in the case-law of the 1960s in favour of a less formalist and less pro-taxpayer stance, so one can sense a shift in the scholarly attitude to canons of tax interpretation. Thus, in a 1969 article, Justice Witkon argued that strict interpretation of tax law was a result of the *laissez faire* atmosphere of nineteenth century liberalism, but today, he stated, it seems that 'the legislator, government and the courts view taxes positively, especially in our country whose special circumstances make maximum taxation a necessity' and therefore one must assume that 'there was an intention to tax the citizen' but, he reassured his readers, this does not mean that this is the age of 'liberal interpretation' which reflects 'unconditional support of the will of the legislator to tax and never to let up'. Instead, Witkon suggested the adoption of 'informed interpretation' which would use economic and other sorts of factual data in order to discover the legislators' intention.[81] This approach evolved in the literature and case-law of the 1970s and 1980s into a wholesale rejection of a strict construction approach to tax legislation in favor of a purposive construction approach.[82]

To sum up this section, it seems that the Israeli case-law, legislation and periodical literature on the issue of tax avoidance and tax interpretation was generally committed to a formalist, pro-taxpayer approach in the 1950s and that as time went by, a more substantive anti-taxpayer approach began to creep into the legal texts, especially in the middle and late 1960s. The next section asks how the history of the doctrines can be explained.

[79] Michael De'uel ed., *Dine Misim* (Tax Law: Based on the Lectures of Justice Witkon) (Jerusalem: Students Association Press, 1954) pp. 34–6. In later editions of the textbook that emerged from these lectures, this strict construction approach remained. See also A. Witkon, 'Darkhe Parshanut'.

[80] See A. V. Klimowsky, 'Perush Hukey Misim' (The Interpretation of Tax Statutes) 2 *R.H.* 181 (1951/2); G. Winograd, 'Al Diney Misim' (Book Review: Tax Law) 1 *R.I.M.* 381, 385 (1965/6), ('the interpretation of the tax statute should be fair, reasonable and true to the words of the law, this is what is usually called 'strict construction'. The claim that a fiscal law should always be construed in favour of the taxpayer is exaggerated and should be carefully used.'). See also Lapidoth, *Evasion*, p. 154 ('Israeli courts have generally applied the principle that taxing statutes should be construed strictly and preferred to look at the form rather than the substance of the transaction in issue').

[81] A. Witkon, 'Be'ayat ha-Parshanut be-Diney Misim' (The Problem of Interpretation in Tax Law) 6 *R.I.M.* 9–11 (1971).

[82] See e.g. Arye Lapidoth, 'Al Nisu'ach Hukey Misim ve-Al Parshanutam' (On the Drafting and Interpretation of Tax Legislation) 8 *R.I.M.* 177 (1976); C.A. 165/82 *Kibbutz Hatzor v Assessing Officer*, 39(2) P.D. 70 (6/5/1985). However, in the 1980s one could still find vestiges of the older, strict construction approach. See e.g. C.A. 364/80 *Director of Property Tax v Proskauer*, 34(3) P.D. 579.

III. EXPLANING THE HISTORY OF THE DOCTRINES

1. Income Tax Doctrines and Class Interests

Income tax was a major political issue dividing Left and Right in Israeli politics in the 1950s.[83] There were several aspects to the debate.[84] One hotly contested issue was the exemptions from income tax granted to the agricultural cooperatives (the kibbutzim) and to the big industrial cooperatives of the socialist parties.[85] Another issue, which seems mainly to have bothered the Israeli Communist party, was that of tax exemptions granted to foreign investors.[86] But perhaps the major political controversy on tax matters in the 1950s was the issue of fair allocation of the income tax burden between employees and the self-employed.

The Israeli Left argued that the tax burden was mainly shouldered by hired workers whose tax was deducted at the source, while the self-employed, who

[83] Applying the terms 'right' and 'left' to the politics of the 1950s maybe somewhat misleading, because the ruling socialist party, Mapai, was in many senses less socialist and more etatist. See S. Karmi and H. Rosenfeld, 'Ha-Kalkala ha-Medinit shel ha-Le'umiyut ha-Militaristit be-Yisrael' (The Emergence of Militaristic Nationalism in Israel) in Uri Ram ed., *Ha-Hevra ha-Yisre'elit: Hebetim Bikortiyim*. (Israeli Society: Critical Perspectives), (Tel-Aviv: Breirot, 1993), p. 275. See also Zeev Sternhell, *Binyan Umah o Tikun Hevra* (Building a Nation or Mending a Society) (Tel Aviv: Am Oved, 1995); Shimshon Bichler & Jonathan Nitzan, *Me-Rivkhey Milkhama le-Dividendim Shel Shalom* (From War Profits to Peace Dividends: The Global Political Economy of Israel) (Jerusalem: Carmel, 2001), 140–75. For an application of this insight to the law, see Ron Harris, 'Legitimizing Imprisonment for Debt: Lawyers, Judges and Legislators' in Ron Harris, Alexandre Kedar, Pnina Lahav & Assaf Likhovski eds., *The History of Law in a Multicultural Society: Israel 1917–1967*, (Dartmouth: Ashgate, 2002), p. 217.

[84] For a comprehensive survey of the political positions of various parties (based on a tripartite division of the Knesset into Left, Right and Center) between 1951 and 1975, see Zvi Shuldiner and Alex Radian, 'Emdotehen shel ha-Miflagot ha-Politiyot be-Yisrael be-Sugyot Nivharot shel Medinyut Mas Hakhnasa' (The Position of the Political Parties in Israel on Selected Issues of Income Tax Policy) 11 *R.I.M.* 103 (1979/80).

[85] See e.g. 2 D.K. 1368–70 (24/8/1949) (MK Y. Bader of the right-wing Herut party criticizing the exemption granted to the 'big ... rich, giant, capitalist' cooperatives of the labor movement, and members of the left-wing Mapai and Mapam parties defending the exemption). See also 15 D.K. 1542 (6/4/1954) (MK Bader complaining that the kibbutzim had paid only miniscule amounts of taxes since the establishment of the state and that the industrial cooperatives of the labor movement are totally exempt); 'Mas Hakhnasa bi-Re'e ha-'Itonut,' (Newspaper Articles on the Income Tax) 4 *R.H.* 56, 86, 198 (1953/4); Shuldiner & Radian, 'Emdotehen,' p. 104. The exemption given to cooperatives was statutory before 1949 and was later based on the discretion of the minister of finance. See e.g. Asher Arin & Ilana Reich, 'Misuy ha-Kibutzim veha-Agudot ha-Shitufiyot (The Taxation of Kibbutzim and other Cooperatives) in Avraham Mandel & Asher Arin eds., *'Idkunim le-Sefer Hitpatkhut ha-Misim be-Eretz Yisrael Legabey ha-Shanim 1964–1978*' (An Update to the History of Taxation in Palestine and Israel 1964–1978) (Jerusalem: Tax Museum Press, 1982), p. 62. See also 'Knesset Abolishes Blanket Tax Exemption for Cooperatives,' *J.P.* 26/8/1949 (reporting that the finance minister was criticized for passing the bill by the left-wing Mapam party and in response said that 'he doubted whether any cooperative would have to pay taxes but the amendment was designed to silence those who said that legislation favored cooperative enterprises over private enterprises').

[86] 15 D.K. 1458–9 (1/4/1955) (MK Meir Wilner, Maki).

had to report their income in order to be taxed, managed to evade paying the income tax. For example, MK Moshe Sne (then a member of the socialist Mapam party) argued in 1950 that 'two thirds and more of the income taxpayers are employees who pay the income tax before they receive their salaries, because the tax is deducted at the source. The remaining third are business owners who pay in arrears one and a half years later [this was before the introduction of a pay-as-you-earn system in Israel], if they do not succeed in totally evading [the tax]. Who carries the burden of the budget therefore? The impoverished classes!'[87]

The Israeli Right rejected these arguments. Knesset members belonging to the parties of the Right argued that workers were evading the income tax as well,[88] or that the burden on the self-employed was unrealistically high, or that urban workers were discriminated in comparison to the agricultural sector (dominated by the Left).[89] Which side in the debate was correct is difficult to determine.[90]

[87] 4 D.K. 1108 (22/3/1950). See also 5 D.K. 1779 (20/6/1950) (Mapai members arguing that the wealthy are evading taxation); 15 D.K. 1537 (6/4/1954) (MK Akiva Govrin, Mapai). See also 'Newspaper Clippings' 1 *Y.P.* 59 (December 1953) (articles in the workers' daily, *Davar*, stating that most of the tax burden is placed on the shoulders of the workers and that the bourgeoisie does not share the burden); 'Income Tax Criticism' *J.P.* 18/7/1952 (reporting that the independent newspaper *Ha'aretz* argued that 'the main burden of the income tax is borne by the wage and salary earners ... while strangely enough for a Mapai-directed government, the bourgeoisie does not pay its full part.'). For the same argument a decade later, see Victor Shem Tov, 'Mas Emet ve-Hishtamtut me-Mas' (Tax and Tax Evasion) 3 *R.I.M.* 311, 312 (1968).

[88] 5 D.K. 1428 (17/5/1950) (MK Eliahu Mazor of the United Religious Front).

[89] 15 D.K. 1535–6 (6/4/1954) (MK Simon Bezerano, General Zionist Party). See also 15 D.K. 1543 (6/4/1954) and 'Leket min ha-Itonut' (Newspaper Clippings), *Y.M.* 8 (December 1955) (quoting an article according to which if tens of thousands evade taxation this is the result of the high tax burden and another article which argued that 'the politicians, members of Knesset and newspapers of the labor movement claimed that the self-employed were evading the burdens imposed by the state ... and the civil (bourgeois) circles claimed that on the contrary, the cooperative enterprises of the kibbutzim and the Histadrut enjoy the support and state funds and do not share the tax burden).

[90] See 9 D.K. 2009–10 (19/6/1951) (reply of the finance minister to a parliamentary question about the division of the burden of income taxation between companies, employees and self-employed); Wayne F. Anderson, *Income Tax Administration in the State of Israel: Report to the Government of Israel* (Tel Aviv, United States of America Operations Mission to Israel, October 1954), p. 4 [a copy of the report can be found at the Jewish National and University Library, Giv'at Ram, Jerusalem] (estimating in 1954 that tax collection from employees 'probably equaled 90% of their full tax liability' while collection from the self-employed is 'probably somewhere between 50% and 65%'); H. S. Loewenberg, 'Ha-Shuma veha-Shfita' (Assessment and Judgement) 15 *Sherut* 6 (May 1961) ('people tell me that in other countries taxpayers avoid paying taxes on 30% of their income in legal (expenses) and illegal (evasion) ways. People say that here in Israel the percentage is higher. I do not believe so'). See also Y. Lipski-Halifi, 'Ha-Atzma'i be-Mas Hakhnasa' (Income Tax and the Self-Employed) 7 *R.H.* 87 (1956/7) (arguing that the burden imposed on the self-employed is heavier than that imposed on employees); Nahum Gross, 'Kalkalat Yisrael' (The Economy of Israel) in *Idan: He-Asor ha-Rishon 1948–1958* (the First Decade) (Jerusalem: Yad Ben Zvi, 1997), 138, 145 (arguing that the tax policy, especially income tax policy, in the first decade after independence 'discriminated against the self-employed in').

Did the debate between the Left and the Right of Israeli politics influence the decisions of the Israeli judges (who came mainly from a middle-class bourgeois background)[91] in a way similar to that identified by Stevens in Britain? There are some indications that class allegiance (in this case to the middle class smarting under a heavy tax burden) may have been partly responsible for the formalist attitude to tax avoidance which some of the judges adopted. When one asks why two very similar tax-planning schemes involving the camouflaging of income from interest by the use of preference shares were treated differently by the Jerusalem and Tel Aviv District Courts in 1959, one might suspect that one of the reasons for the different treatment was that one of the taxpayers (the one whose tax planning scheme was rejected) was a company belonging to the Histadrut, the General Federation of Labour.[92]

Another, more explicit, indication that class animosity may have had an impact on the decisions of the judges can be found in a 1966 article written by Justice Witkon in which he attacked the unfair distribution of the tax burden and argued that this burden falls most heavily on 'middle incomes, those of the members of the free professions, managers and educated and skilled workers; in short, all those whose productive work is most vital to the country.' In this article, Witkon noted that only in Sweden were the marginal rates on middle-class taxpayers higher than in Israel. He also criticized the Israeli Government for succumbing to pressure from the Labor Unions and raising salaries on the one hand while attempting to balance the budget by raising taxes on the other. He rhetorically asked 'can one blame those who do not see the thin line of difference between opposition to a Government salary policy which they do not like and acts of sabotage against tax collection?'[93] More specifically, the argument that the tax burden was unfairly distributed was used by Witkon to justify the limited use of the general anti-avoidance provision. Witkon argued that it is wrong to empower judges (instead of the legislature) to decide which transactions are normal and which are artificial as the general anti-avoidance provision required, because such decisions are not 'above party and political quarrel and therefore [are not] fit to be decided by the courts. In this area [tax law]

[91] See e.g. Fania Oz-Salzberger and Eli Salzberger, 'The Secret German Sources of the Israeli Supreme Court,' 3 *Israel Studies* 159 (1998).
[92] Compare I.T.A. (Jerusalem) 25/58 *Ploni v Assessing Officer*, 19 P.M. 345 and I.T.A. (Tel Aviv) 713/58 *Hevra Plonit v Assessing Officer*, 21 P.M. 334.
[93] One blatant example of the way the Government succumbed to the pressure of strong unions is the way the salaries of the employees of the national airline, El Al, were paid in the 1950s and 1960s. The air crews of El Al got their salaries in English Pounds. Their income tax, however, was calculated based on a fictitious exchange rate where one English Pound equaled one Israeli Pound. Since the actual exchange rate was higher, this extra-legal tax concession reduced their tax. See Israel State Archive, Ministry of Justice file GL-21324/3, letter from Attorney General Meir Shamgar to Deputy Finance Minister Zvi Dinstein, 20 December 1972.

there are many forms of discrimination between various methods of tax avoidance. For example, benefits that certain kinds of self-employed and employees enjoy and which undermine fiscal morality in a far more serious way [than tax avoidance] but these benefits are backed by powerful pressure groups and the authorities cannot touch them.'[94] It seems that Witkon's arguments in this article indicate that one of the factors that led him to adopt a pro-taxpayer attitude in the 1950s and early 1960s was his conviction that targeting 'bourgeois' tax-avoiders was unfair as long as labor unions were able to enjoy legally-sanctioned ways of avoiding taxation.

2. Legal and Psychological Factors Effecting the Judges

Class interests seem to partially explain the formalist, pro-taxpayer bent of Israeli anti-avoidance doctrines in the 1950s but they do not explain the gradual waning of the pro-taxpayer bent in the 1960s. Another possible way to explain the history of the doctrines is by reference to legal and psychological factors effecting the judges.

1) The Influence of British Law and the Formalist Style of Judicial Reasoning

One can argue that the formalist, pro-taxpayer attitude to tax-avoidance in Israel in the 1950s was the result of the impact of British formalist approaches to tax avoidance. The Israeli Income Tax Ordinance was enacted by the British in 1941. It was not based directly on English income tax legislation but rather on a colonial model. Unlike other ordinances enacted by the British in Palestine, the income tax ordinance did not contain a provision that instructed the judges to turn to English law in order to interprete the ordinance.[95] This led some British judges in the 1940s to argue that English income tax law was irrelevant to the law of Palestine.[96] However, in subsequent cases decided during the British Mandate period and in early Israeli cases, the judges did turn to English case law when interpreting the Income Tax Act.[97]

The impact of English formalism certainly had some effect on Israeli judges. Thus for example, in his 1966 review of Lapidoth's book, Justice Witkon did turn to English precedents to justify the scant use of the Israeli

[94] Witkon, 'Bikoret Sfarim,' pp. 525–7.
[95] See Wilkenfeld, *Taxes,* pp. 205–6.
[96] I.T.A.2/44 *Gesundheit v Assessing Officer*, (1944) P.L.R 265.
[97] See C.A. 310/44 *Gesundheit v Assessing Officer,* A.L.R 1945, 294. See also Lapidoth, *Evasion*, pp. 23–25; Witkon, 'Darkhe Parshanut,' p. 15. For a quantitative study of the use of English law by Israeli judges in the 1950s, see Yoram Shachar, Ron Harris & Miron Gross,

anti-avoidance provision.[98] However, English influence could cut both ways, because there were also British cases that adopted an anti-formalist stance. Thus, Witkon himself noted in the middle 1940s that 'recently the English House of Lords has rebuked taxpayers and their professional advisers who invent such [artificial] schemes even if the law 'allows' them to use them' citing the *Latilla* case of 1943.[99]

In addition, one should note that when Israeli judges did not want to use English precedents, they were quick to reject them. This is seen clearly in the 1959 *Hevra Plonit* case. When the lawyer representing the taxpayer tried to rely on the *Duke of Westminster* case in order to convince the court to adopt a formalist position respecting the 'form of the transaction', Judge Loewenberg rejected his approach referring to the speech by Lord Simon in *Latilla* which stated that 'there is no reason that the effects of [anti-avoidance schemes] should be regarded as a commendable exercise of ingenuity or as a discharge of the duties of good citizenship.' Based on *Latilla*, Loewenberg added, it seems that even in England there is a tendency to examine the substance of the transaction and not just its form. Loewenberg also noted that it would be more appropriate to turn to American rather than to English law, and that in the United States the rule is that it is allowable to 'pierce the veil of certain monetary relationships in order to see if the form of transaction chosen by the parties is not void because it is artificial and leads first and foremost to tax avoidance.' Finally, in this as well as in other cases, Loewenberg also noted that in English law there was no provision similar to the Israeli general anti-avoidance provision and that even if there had been no such section in Israeli law, unlike most British ordinances adopted during the time of the Mandate, the Income Tax Ordinance did not contain a provision obliging judges to refer to English law in order to interpret the ordinance.[100] Therefore, the fact that English law was or was not formalist in the 1950s cannot explain the Israeli decisions.

Another possible way to explain the pro-taxpayer decisions of the Israeli courts in the 1950s and 1960s is by tying them to the history of judicial reasoning styles in Israel. Until the middle of the 1970s, partly as a result of the influence of British legal traditions on the nascent Israeli legal system, the dominant style of judicial reasoning in Israel was formalist.[101] One can

'Nohage Histamkhut shel Bet ha-Mishpat ha-Elyon: Nitukhim Kamutiyim' (Citation Practices of the Supreme Court: Quantitative Analyses) 27 *Mishpatim* 119 (1996).

[98] Witkon, '[Book Review]', 1 R.I.M., 526.

[99] Wittkowski, 'Mas Hakhnasa: Skira,' pp. 120, 121.

[100] I.T.A. 713/58 (Tel Aviv) *Hevra Plonit v Assessing Officer*, 21 P.M. 334, 339–40, 343. For a similar argument in the *Mefi* case, see I.T.A. (Tel Aviv) 957/66 *Mefi Ltd. v Assessing Officer*, p. 3.

[101] See Menachem Mautner, 'Law and Culture in Israel: The 1950s and the 1980s,' in Harris et al. (eds.), *The History of Law in a Multicultural Society* (discussing the formalist style and proposing

argue that the formalism of Israeli anti-avoidance doctrines in the 1950s and early 1960s was merely a reflection of more general conceptions of proper judicial style and activity.

However, Justice Witkon, one of the leading creators of Israeli anti-avoidance doctrines, was also one of the least formalist justices on the Israeli Supreme Court. In his works, Witkon stressed time and again that tax law could not be understood without referring to its economic and social background, and declared his allegiance to a sociological-jurisprudence conception of law.[102]

2) *Psychological Factors Effecting the Judges*

One of the ways in which Justice Witkon sought to explain his formalist approach to tax-avoidance was to argue that this formalism was the result of psychological factors. According to Witkon, in the contest between the taxpayer and the state, judges tend to identify with the weaker party, the citizen. 'In most tax matters,' he noted in an article on tax interpretation, the judges find for the taxpayer 'who is considered weak and in need of the defense of the court. Based on my experience, … in many cases – too many cases – the interest of the State is not strong enough to have justified the prosecution of the citizen.'[103]

Another related explanation that Witkon mentioned was more economic in nature: 'Any conscientious judge is afraid that he may be wrong in his decision and it is clear that a pro-taxpayer mistake in the interpretation of the law is better that a anti-taxpayer mistake since usually the citizen does not have the required economic means to face the effects of a mistaken decision. On the other hand, a taxpayer who has been unjustly exempted is just one of many tens of thousands of taxpayers who have escaped the tax net. In this sense fiscal law is similar to criminal law.'[104]

An additional explanation for the pro-taxpayer approach of the courts had to do with the fact that in the contest between the taxpayer and the State, it was the State that made the rules. This was one of the reasons that

some reasons for its dominance in 1950s Israeli law). For more general discussions of the formalist style of judicial reasoning see e.g. Robert S. Summers, *Instrumentalism and American Legal Theory* (Ithaca: Cornell University Press, 1982); Anthony T. Kronman, *Max Weber* (Stanford: Stanford University Press, 1983); Thomas C. Grey 'Langdell's Orthodoxy,' 45 *University of Pittsburgh Law Review* 1 (1983); Morton Horwitz, *The Transformation of American Law* 1870–1960 (Cambridge MA: Harvard University Press, 1992).

[102] A. Witkon, *Mavo le-Dine Misim* (Introduction to Tax Law) (Jerusalem: Schoken, 1957), introduction; A. Witkon, 'Accountancy and Law,' 8 *R.H.* 95, 95–6 (1957/8). See also A. Witkon, 'Ha-Mishpat be-Eretz Mitpatakhat' (Law in a Developing Country) in A. Witkon, *Mishpat ve-Shiput* (Jerusalem: Schoken, 1988), 40.
[103] Witkon, 'Darkhe Parshanut,' 14.
[104] *Ibid.*

was used to justify the pro-taxpayer attitude of British courts: since income tax law could easily be amended by the annual finance acts, the courts should rule in favour of the taxpayer and if the decision was wrong it would be amended by the legislature.[105] One can find an echo of this approach in the Witkon's writings as well. In 1954 Witkon taught a course called 'Introduction to tax law' at the Hebrew University of Jerusalem. In this course, Witkon told his students that in the battle between the taxpayer and the Revenue, the Revenue has an advantage because it can amend the law at will, and therefore the courts are not obliged to further assist it by using a 'liberal pro-state interpretation in cases of tax avoidance' The courts, he later added, should adopt a 'neutral' or 'realistic' position between the taxpayer and the state and if there are any loopholes in the law, it is the duty of the legislator to deal with them.[106]

One final factor that may explain the pro-taxpayer tendency of the courts is, perhaps, an innate desire for certainty. As John Tiley has argued in the British context, the adoption of the substance over form principle can lead to legal chaos and judges may be simply fearful that adopting an anti-formalist approach could enhance legal uncertainty.[107] It should be noted however, that one can easily point to factors that pull in the opposite direction. Thus, it has been suggested that adopting a anti-formalist stance is psychologically more satisfying for the judges, both because it casts them as 'statesmen' and also because it prevents them from being seen as naive.[108]

In the Israeli context, the desire not to appear naive may also have been tied to ethnic factors. Many of the Israeli judges in the 1950s (including Justice Witkon and Judge Loewenberg) were German-born Jews (derogatorily called 'Yekkes' by other Israelis).[109] A common stereotype among native-born Israelis was that German-born Jews were law-obeying suckers who (among other things) never evaded taxation.[110] Prosecuting tax evaders

[105] See Williams, 'Taxing Statutes', 406. See also Tiley, [1988] *British Tax Review*, 144–5 (noting that the way tax law was formed in the United States left far more discretion to judges in creating 'tax jurisprudence' than in the UK).

[106] De'uel, *Dine Misim,* p. 39. See also Witkon, *Mavo,* pp. 35-6; Witkon, *Mavo* (2nd edn., 1962), p. 42.

[107] John Tiley, 'Judicial Anti-Avoidance Doctrines: Corporations and Conclusion,' [1988] *British Tax Review*, 108, 134–6.

[108] Isenberg, 'Musing on Form and Substance,' 882 ('judges have aspirations … . Little attention is drawn to those who hew narrowly to technical rules. The painstaking process of examining transactions and statutes to determine whether they concord promises little glory. In a society that has always looked to courts for strokes of statesmanship, it is easy enough to understand a judge's temptation to cut through rather than unravel the Gordian knot. A simpler variant of this attitude is the desire not to look naive, to understand what is "really going on"').

[109] Oz-Salzberger & Salzberger, 'The Secret German Sources.'

[110] Yoav Gelber, *Moledet Hadasha* (New Homeland) (Jerusalem: Leo Baeck Institute, 1990), p. 233.

and ignoring tax avoidance schemes would thus have been seen as a sort of 'revenge of the suckers'. Perhaps one can find an indication of such an approach in a speech given in 1957 by Attorney General Haim Cohn, another German-born Jew. In this speech, Cohn complained about the low morality of the Israeli taxpayers. 'Anyone who manages to contravene provisions of the Income Tax Act and pay a little less than he has to pay' he said, 'is not considered to have committed a crime but [to have done] a good deed, and public opinion views him positively; [indeed], far more positively than those who pay their income tax to the last penny. *These are considered 'Yekkes'* [emphasis added].*'* [111]

3. Tax Administration

It is very difficult to assess the effect of class-interests and other factors on the shaping of anti-avoidance doctrine. One cannot quantify psychological factors or class loyalty. I believe that these factors played some role, but it also seems to me that they are not the only factors, and that a comprehensive history of tax-avoidance in Israel must also take into account the history of tax evasion and the ways adopted to combat it.[112]

1) Tax Evasion

During the last decade of British rule in Palestine, the Jewish community established a system of self-imposed taxes designed to finance defense and illegal immigration. Since British-Jewish relations during the last years of the mandate were strained and sometimes erupted into violence, the evasion of Government-imposed taxes was socially encouraged in the

[111] Haim Cohn, '[Symposium]: Shiput ve-Hamarat Mishpat be-Kofer Kesef' (Judgment and Monetary Penalties) 5 *Sherut* 3, 5 (July 1957).

[112] One can also explain the shift in the cases by reference to economic changes. The years 1954–1965 were years of rapid economic growth. Between 1965 and 1967, the Israeli economy went into a deep recession and began to recover only after the victory in the June 1967 war. See e.g. Gross, 'Kalkalat Yisrael.' Following victory in the war, a general amnesty including a tax amnesty was declared. The cut-off date for the amnesty was 7/11/1967, only 12 days before the decision in the *Mefi* case. See Wilkenfeld, *Taxes*, pp. 245–249. See also '"Erev Iyun: Hok Mas Hakhnasa [Hatsharot Metaknot], 1967' (Symposium on the Amnesty Law) 17 *R.H.* 453–468 (1967); Zvi Wechsler, 'Me-Gilyon le-Gilyon' 3 *R.I.M.* (1968), unnumbered page; Naftali Birkenfeld, 'Halbanat Hon be-Mivhan ha-Bitsua' (Money Laundering) 3 *R.I.M.* 168 (1968); Arye Lapidot, 'Al ha-Haninot be-Tkhum ha-Misim' (On Tax Amnesties) 3 *R.I.M.* 173 (1968); David Krivine, 'For Real Offenders Only' *J.P.* (1/2/1968). Perhaps one can argue that the judges felt that tax evaders and tax avoiders were given a chance to correct their ways and that the *Mefi* case should signal a new tough attitude toward unreconstructed tax evaders.

Jewish community.[113] This was especially true of the income tax, which was perceived as 'an insidious means for taxing the urban Jew for the benefits [sic] of the agrarian Arab.'[114]

One could have expected that after the establishment of the State of Israel in 1948, Israelis would pay their taxes willingly, especially given the precarious security situation in which they found themselves in the early 1950s. Thus David Z. Penkas, the chairman of the Knesset Finance Committee declared in a 1950 speech that 'every person in Israel should feel joy because he gained the right to pay taxes to the State of Israel which are used to ensure its existence and development. We [Jews] who had paid taxes to many foreign nations during our long years of Exile, have now finally won the right to pay taxes to ourselves ...'[115] Perhaps another indication of the intimate connection between taxation and security in the first years after the establishment of the State was that in speeches in the early 1950s, Knesset members called tax evaders 'deserters' a term with extremely negative connotations.[116]

During the first months after independence, the desire to pay taxes to the new State may indeed have been strong.[117] But very soon, the early idealism waned as the Government imposed austerity measures that eroded living standards and extracted more and more money out of the new citizens using a series of compulsory loans.[118] In reaction, Israeli taxpayers started evading taxes *en masse,* ignoring the patriotic rhetoric of their politicians.[119] The newspapers and periodicals of the early 1950s contain many statements lamenting the fact that tax evasion was

[113] Wilkenfeld, *Taxes*, pp. 3–4.

[114] Anderson, *Income Tax Administration*. p. 1. 75% of the income tax payers in Palestine in 1945 were Jews despite the fact that the Jews constituted only 30% of the population. See Mandel, *Hitpatkhut*, p. 4. For a pre-1940s argument on the distribution of tax burden between the two communities in Palestine, see A. Granowsky, *Shitat ha-Misim be-Eretz Yisrael* (The Tax System in Palestine) (Jerusalem: The Economic Department of the Jewish Agency, 1933) pp. 359–61, 371–2.

[115] 5 D.K. 1778 (20/6/1950).

[116] 5 D.K. 1803 (21/6/1950) (Finance minister E. Kaplan).

[117] See Hanan Cohen, 'Mas Hakhnasa bi-Yeme ha-Mandat uve-Yameha ha-Rishonim shel ha-Medina' (Income Tax during the Mandate and the First Days of the State) 8–9 *Sherut* 5, 9 (August 1958) ('even though the citizens of the new state knew that after independence they would have to pay higher taxes than those they paid until then to the Government of the Mandate, they enthusiastically came to pay their taxes. Two well known citizens of Haifa argue between them even today who was the first taxpayer in Haifa).

[118] The first compulsory loan was imposed as part of the new economic policy of 1952, and was followed by a series of loans and defense duties throughout the 1950s and early 1960s. See Mandel, *Hitpatkhut*, pp. 78–103.

[119] For an interesting social history of the early 1950s, see Tom Segev, 1949: *Ha-Yisre'elim ha-Rishonim* (1949: The First Israelis) (Jerusalem: Domino, 1984), pp. 280–305.

widespread.[120] In late 1953, a newspaper article published in *Davar*, the organ of the ruling socialist Mapai party stated that of 560,000 breadwinners in Israel, only 300,000 were registered by the Revenue, 250,000 of those registered were employees and only 50,000 were self-employed. The article asserted that there were 150,000 self-employed who evaded the income tax.[121] An American expert who advised the Israeli Government on tax matters described the period between 1951 and 1955 as one in which tax resistance and evasion were growing rapidly.[122] Tax compliance conditions in Israel of 1951/2 were described only five years later in 1957 as similar to those of the 'Wild West.'[123]

Perhaps the climax of the war between the Revenue and the taxpayer was reached in 1954 when the income tax became a major issue of political contention between the socialist-led government of Mapai on the one hand and the right-wing Herut and centrist General Zionist parties on the other hand. The conflict led to taxpayers strikes. Finally, in October 1954, a crisis erupted following the suicide of a Jerusalem confectioner, Israel Sinai, who left a suicide note blaming the income tax collectors for his death. Mr. Sinai's suicide was followed by a major tax strike and by the establishment of a special government committee headed by Justice Witkon to study the circumstances that led to of the suicide.[124]

[120] See e.g. 2 D.K. 1367 (24/8/1949) (Knesset finance committee chairman Penkas declaring that there were 122,000 income tax payers but 'tens of thousands of eligible payers do not pay the tax'), 5 D.K. 1803 (21/6/1950) (finance minister E. Kaplan complaining that tax evasion is a 'national sport'); 15 D.K. 1527 (5/4/1954) (finance minister Levy Eshkol stating that tax evasion is widespread); A. Shtark, 'Od 'al Yahase Tsibur' (More on Public Relations) *Y.P.* 50, 52 (October–November 1953) (the plague of tax evasion has engulfed all classes of the public). 'Leket min ha-'Itonut' (Newspaper Clippings) *Y.P.* 8 (December 1955) (quoting a article in *Ha'aretz* that states that 'the general impression is very bad, both because [it seems] that the morality of the taxpayers is low and the efficiency of the Revenue [is also low]'); T. Brosh, 'Be'ayat Bitsu'a Hok Mas Hakhnasa' (Enforcement Problems in Income Tax Law) 1 *Sherut* 3 (June 1956). See also Gross, 'Kalkalat Yisrael', p. 138. There were isolated remarks to the contrary. See 'Leket min Ha-'Itonut' (Newspaper Clippings) *Y.P.* 58 (December 1953) (reporting a speech delivered by the Income Tax Commissioner according to which the number of tax evaders is not large).

[121] 'Ha-Tafkid ha-Rishon: Tosefet 150,000 Meshalme Mas Hakhnasa' (The First Priority: An Additional 150,000 Taxpayers) *Davar* reprinted in *Y.P.* 60 (December 1953). For a similar claim by Revenue people, see Dov Ben-Amitai, 'al ha-Ezrakh Lemale Khovato' (The Citizen Should Fulfill his Duty) *Y.P.* 65 (April 1954).

[122] Wilkenfeld, *Taxes*, p. 3.

[123] 'Shiput ve-Hamarat Mishpat be-Kofer Kesef' (Judgment and Monetary Penalties) 5 *Sherut* 3, 8 (1957). Of course, we now know that the image of lawlessness of the 'Wild West' may have been misleading. See John Phillip Reid, *Law for the Elephant: Property and Social Behavior on the Overland Trail* (San Marino: Huntington Library, 1980).

[124] Wilkenfeld, *Taxes*, pp. 8–13. See also 'Taxes, Cost of Living Lead to suicide,' *J.P.* 3/10/1954; 'Hit'abed me-Khamat Omes ha-Misim' (Committed Suicide because of the Tax Burden) *Ha'aretz* 3/10/1954; 'The Merchants' Secretary: The Tax Burden Ruins the Middle Class,' *Ha'aretz* 26/10/1954; 'P.M. Orders "Tax Suicide" Inquiry,' *J.P.* 20/10/1954; 'Suicide held not Responsible for Impending Tax Strike,' *J.P.* 25/10/1954; 'Sinai C'ttee Clears

Beginning in 1953, the tax authorities sought to deal with wide-spread tax evasion using a variety of means.[125] In late 1953 the Revenue began a campaign for the prosecution of tax evaders, which was not very successful because the law did not provide sufficient penalties for tax evasion. Additional reasons for the lack of success was that the tax administration system was still relatively disorganised and that the courts tended to impose light sentences on the offenders taking into consideration the fact that the income tax collection machinery was not functioning properly.[126]

In 1954, the Income Tax Act was amended in order to increase criminal penalties for tax evasion,[127] and in 1955 the Revenue initiated a criminal prosecution program. At first this program met with only partial success; in the first years of the program, judges still tended to impose light sentences on tax evaders (the first jail sentence was imposed only in 1959).[128]

Other means to fight tax evasion were used. For example, in 1955 the Revenue initiated the publication of a register containing the tax assessments of Israeli tax payers (*Sefer Nishomim*) in which the returns for 1952/3 were published.[129] Tax amnesties were declared in 1954 and 1958.[130]

Tax Authorities,' J.P. 1/11/1954; 'The Witkon Committee's Report,' *Ha'aretz* 1/11/1954. Tax strikes were common in 1954. The year began with another strike by small businessmen and artisans. See 'Shops to Close in Tax Protest,' *J.P.* 29/1/1954; 'Artisans Call Two-Day Strike in Protest of 'Fantastic' Taxes,' *J.P.* 8/2/1954.

[125] For a detailed history of the anti-evasion measures of the 1950s, see Wilkenfeld, *Taxes*, pp. 209–251.

[126] Wilkenfeld, *Taxes*, pp. 209–11; A. Shtark, 'More on Public Relations' *Y.P.* 50, 52 (October-November 1953) (the plague of tax evasion has engulfed all classes of the public but the judges pity the offenders). The exact date of the first case in which criminal charges for income tax fraud were filed is not clear. Compare Wilkenfeld, *Taxes*, p. 209; 'School Director Freed of Tax Charges,' *J.P.* 6/7/1950; 'First Trial in Israel on Income Tax Fraud,' *J.P.* 7/3/1952; 'Gov't Files Criminal Suit for Non-Payment of Income Taxes,' *J.P.* 3/2/1953. On the 1953 campaign, see 'Action against Tax Evaders,' *Davar*, reprinted in *Y.P.* 63 (December 1953). See also C.C. 486/53 (Haifa) *Attorney General v. Z.S.*, reprinted in *Y.P.* 67 (December 1953); C.A. 276/53 *Kahana v. Attorney General*, 8 P.D. 404 (fining tax evaders stating that since these are the first criminal cases the court will only impose a light punishment); 'Criminal Cases,' *Y.P.* 75 (April 1954) (reporting 12 criminal cases decided by the Tel Aviv District Court in February 1954).

[127] See e.g. 15 D.K. 1527ff. (5/4/1954) (discussing the 1954 Income Tax Act Amendment Law which sought to increase the penalties for tax evasion).

[128] Wilkenfeld, *Taxes*, pp. 214–224. See also Wilkenfeld, 'Shiput,'; Y. Wilkenfeld, 'Zekhuyot Meshalme ha-Misim lefi Pkudat Mas Hakhnasa' (The Rights of the Taxpayer according to the Income Tax Act) 1 *Sherut* 5 (June 1956); T. Brosh, 'Agaf Mas Hakhnasa bi-Shnat 1955/56' (The Income Tax Department in 1955/56) 1 *Sherut*, 34, 35.

[129] 'Tax Assessments Published for Self-Employed Earners,' *J.P.* 10/9/1955; 'Leket min ha-'Itonut' (Newspaper Clippings) *Y.P.* 8 (December 1955); 'Income Tax Register Released: Sharef Doubts its Efficacy,' *J.P.* 26/8/1957. The experiment was discontinued after two years. See Lapidoth, *Evasion*, pp. 64–65.

[130] Wilkenfeld, *Taxes*, pp. 215–18. There were earlier tax amnesties in the 1950s. See 'Delinquent Taxpayers Get "Amnesty"' *J.P.* 4/11/1952; 'Notices to the Public: Income Tax Payments,' *J.P.* 12/12/1952; 'You Pay Yourself [advertisement]' *J.P.* 23/12/1952; 'April 'Amnesty' for Evaders' *J.P.* 7/4/1954; 'Tax Amnesty Results Startling,' *J.P.* 16/4/1958.

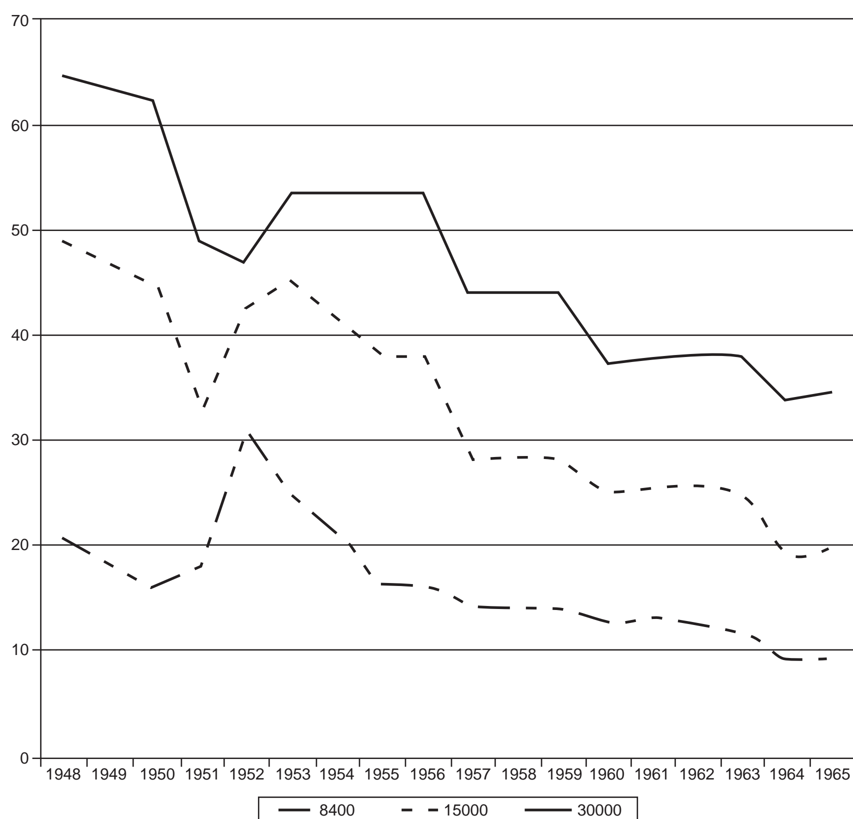

Figure 1: Effective tax rate for a married employee with two children (tax as percentage of income for three sample annual incomes).
Source, Mandel, Hitpatkhut ha-Misim be-Eretz Yisrael, p. 73, table 34.

An information service (*Shin-Alef*) was set up in 1954.[131] Extensive activities were undertaken in order to encourage the keeping of account books.[132]

Another method of creating tax compliance was by increasing public participation in the tax assessment process and reducing the discretion of the assessing officers, thus increasing trust in the Revenue. The Revenue set up advisory committees which included members of the public and which assisted the authorities in the process of assessments.[133] In addition,

[131] Wilkenfeld, *Taxes*, pp. 219–220. It was abolished in 1958. See also N. Birkenfeld, 'ha-Makhlaka le-Khakirot vele-Mishpatim Plilim' (The Department for Investigation and Criminal Cases) 10 *Sherut* 56 (February 1959).
[132] Anderson, *Income Tax Administration*. pp. 7–12; Lapidoth, *Taxes*, p. 81ff.
[133] Lapidoth, *Evasion*, p. 90ff.

the assessment process became standardised following the introduction of calculation charts used in estimated assessments.[134] Another method of fostering trust were initiatives for education campaigns,[135] and public-relations campaigns.[136] The Revenue even resorted in 1955 to the production of an income tax movie which was called 'the Zippori Story' and which told the tale of a tax resister who dreams of organising a movement against the income tax only to discover that all Government services had been shut down for lack of funding.[137] Ultimately perhaps, the most important factor that contributed to the successful campaign against tax evasion was the continuous growth in real income per person (which grew by an annual average of 6% between 1950 and 1965)[138] and the simultaneous reduction of the tax burden. Thus, for example, between 1953 and 1956 the effective income tax burden on low-income taxpayers was reduced by about 40% [figure 1].[139]

The years 1948–1961 are considered the formative years of the Israeli tax system. This was the period in which the tax administration system developed and matured.[140] By the beginning of the 1960s the system finally overcame many of the initial problems involved in fighting tax evasion. Between 1960 and 1964 the number of prosecutions for tax evasion stabilized at

[134] Lapidoth, *Evasion*, pp. 79–81.

[135] Anderson, *Income Tax Administration*, p. 22 (reporting a proposal 'to assist the Ministry of Education in the development of a course in taxation to be taught in the secondary schools and perhaps in the armed forces'); 'School Students to Study Tax System,' *J.P.* 14/12/1956; Y. Artzi, 'Yakhase Tsibur be-Minhal ha-Hakhnasot' (Public Relations in the State Revenue Division) 4 *Sherut* 21 (April 1957) (reporting a seminar for history and civics teachers in high schools on tax matters). See also Shulamit Aloni, 'Al ha-Khinukh le-Toda'at ha-Mas ke-Korakh Tzodek' ('On Education on Taxation as a Just Duty,') 3 *R.I.M.* 205 (1968) (a Knesset member calling for the institution of a special course on taxation in schools); 'Ma'arekhet ha-Misim be-Yisrael: Homer Ezer la-More be-Nos'e ha-Misim' (Book Review: The Tax System in Israel: Materials for Teachers Teaching Taxation) 4 *R.I.M.* 346 (1969).

[136] See e.g. H. Wiliamowsky, 'Yakhase Tsibur' (Public Relations) *Y.P.* 20 (April-May 1953); 'Yakhase Tsibur: Hemshekh' (Public Relations: Continued) *Y.P.* 15 (June–July 1953); M. Y., 'Al Saf ha-Shana' (On the Threshold of the Year) *Y.P.* 3 (April 1954); Gila Uriel, 'Yakhase Tsibur' (Public Relations) *Y.P.* 5 (December 1955). Other measures adopted in following decades were the establishment of a tax museum designed to serve as part of the information and public relations arm of the Revenue. See 'Ha-Museon le-Misim – Pone Elecha!' (The Tax Museum Calls You) 20 *Sherut* 3 (September 1964) and the use of public opinion polls. See D. Bar-Haim, 'Seker Da'at Kahal be-Nosei ha-Misim' ('Public Opinion Polls in Tax Matters,') 9 *R.I.M.* 77 (1974); 15 D.K. 1539 (6/4/1954) (Eliahu Moshe Genikhovsky of Ha-Poel ha-Mizrakhi calling for a propaganda campaign).

[137] Anderson, *Income Tax Administration*, pp. 7, 24–25 (describing how the income tax movie was made based on movies sent to Israel by the Kentucky Department of Revenue and reporting that 'audience response was favorable everywhere and the movie even drew applause at many showings').

[138] Mandel, *Hitpatkhut ha-Misim be-Eretz Yisrael*, p. 6.

[139] *Ibid.*, p. 74 (table 36).

[140] Yosef Gabai, 'Ha-Mediniut ha-Fiskalit be-Yisrael ba-Shanim 1948–1978' (Fiscal Policy in Israel 1948–1978) in Mandel & Arin eds., *Idkunim le-Sefer Hitpatkhut ha-Misim be-Eretz Yisrael,* pp. 3–5.

around 300 cases per annum.[141] There were still complaints,[142] but there were also signs that the campaign against tax evasion was beginning to bear fruit. One indication of this was that judges were now more willing to impose jail sentences on tax offenders. Thus, while judges in the 1950s imposed only light fines using the fact that tax evasion was widespread as a mitigating circumstance, in the early 1960s, imprisonment became more common.[143] Perhaps another manifestation of the success of the anti-evasion campaign was that the newsletter of the Revenue contained fewer discussions of evasion.

Another indicator is the growing reach of the tax authorities. When the British Mandate ended in 1948, there were 90,000 income tax payers. In 1962–63 the number of taxpayers increased by a factor of 7 to 600,000 taxpayers (while the population of Israel only doubled during the same period).[144] Tax collectors were also reaching sectors of the population that were not taxed before, for example, Israeli Arabs.[145] In the late 1950s and early 1960s, the tax collection machinery matured. Criminal prosecutions multiplied (in 1960 the income tax commissioner claimed that the proportion of criminal prosecutions for tax evasion in relation to the number of taxpayers in Israel was one of the highest

[141] Wilkenfeld, *Taxes*, pp. 241–2; Lapidoth, *Evasion*, pp. 122–3; Ze'ev Sharef, 'Hartza'at Mar Ze'ev Sharef' (Lecture at a meeting of the Tax Authorities with members of the Accountants Union) 10 *R.H.* 135, 140–1 (1959/60).

[142] See Dov Yosef, 'Darkhe 'Anisha' (Means of Punishment) 17 *Sherut* 3 (June 1963) (The Justice Minister accusing the judges of being too lenient when punishing tax evaders).

[143] Wilkenfeld, *Taxes*, p. 242. See e.g. Criminal Appeal (Tel Aviv) 297/61 *K.B. Ltd., v Attorney General*, 12 *R.H.* 216–17 (1962); Criminal Appeal 96/64 *Attorney General v Boneh Yotser*, 14 *R.H.* 482 (1964) (cases stating that imprisonment should be the proper punishment for tax evaders and that there is a need to use this punishment in order to express publicly the Court's view on this matter).

[144] Mandel, *Hitpatkhut ha-Misim be-Eretz Yisrael*, pp. 21, 51.

[145] In the early 1950s the government could not collect taxes in the Arab sector. See 'Income Tax Collection,' *J.P.* 12/3/1952 ('it was distressing to hear a Government spokesman admit this week for example that no income tax whatever is collected from Arab farmers'). See also 'Arab Tax: Collection Problems,' *J.P.* 22/6/1954; 'Minority Duties,' *J.P.* 22/6/1954. Beginning in 1955, collection improved. See Gideon Weingert, 'Rise in Arab Tax Collection,' *J.P.* 6/3/1955; 'Knesset Concludes Tax Reform Debate,' *J.P.* 19/12/1956 (reporting that Arab Knesset members attacked the 'arbitrary methods of the tax assessors in the Arab areas'); M. Elfandari, 'Ye'ul ve-Shipur Darkhe ha-Gviya' (Improvement in Tax Collection Methods) 3 *Sherut* 8, 9 (December 1956); A. Sa'ad, 'Mas Hakhnasa be-Kerev he-Mi'utim be-'Asor le-Yisrael' (Income Tax Among the Minorities during the First Decade of Israeli Independence) 8–9 *Sherut* 14 (August 1958); Major Sasson Ben Zvi, 'Shivte ha-Bedu'im be-Nafat Be'er Sheva' (The Bedouin Tribes in the Beer Sheba District) 10 *Sherut* 46 (February 1959); 'Awad Abdallah Ibrahim al-'Abdallah, Be-Shem 'Ekhay Netsige ha-Kfarim ha-' Arviyim' (In the Name of my Brothers the Representatives of the Arab Villages) 13 *Sherut* 11 (1960); 'Arab MK's Motion Divides Coalition,' *J.P.* 7/1/1960 (reporting that an Arab Knesset member charged that 'the tax officials were making the lives of Arab farmers "an intolerable hell" '); Gideon Winegart,

in the world).[146] Fines became heavier and imprisonment for tax evasion, rarely used by the courts in the 1950s, became more common in the early 1960s. One final mark of the maturity of the system was the public reaction to tax related suicides. In 1966, a suicide which was very similar to the 1954 Sinai affair passed almost unnoticed.[147]

It seems that the change in the attitude of the courts to tax avoidance can be understood in this context. The fact that there were almost no cases in which the general anti-avoidance provision of the Income Tax Act was mentioned before 1957 and that until the middle 1960s judges were reluctant to use the provision seems to be connected to the history of tax evasion in Israel. When one considers that there was little *criminal* prosecution for tax evasion before 1955; that when cases for evasion did reach the courts in the 1950s, judges were very lenient; and that the early tax administration machinery seemed to have lacked the required sophistication to deal with tax avoidance, one understands why the courts were not very keen to intervene in the relatively few cases of tax avoidance that did reach them.[148]

2) *Law in a Developing Country*

Another aspect of the impact of tax administration on the shape of anti-avoidance doctrines is the link found in the literature between the issue of tax avoidance and the 'tax administration in a developing country' discourse.

In a 1956 report written by an American expert, Wayne Anderson, on Israeli tax administration, it was argued that one of the major reasons for the problems in tax collection in Israel was the heterogeneity of the population – a 'new and divergent population that represented a tremendous

'Mas Hakhnasa be-Kerev ha-Mi'utim' (Income Tax and the Minorities) *Haaretz* 14/9/1960 (reprinted in 14 *Sherut* 31 (December 1960)).

[146] 'Pgishat Havrei ha-Lishka Im Netzigey Shiltonot ha-Mas' (Meeting of the Members of the [Accountants Bar] with the Income Tax Commissioner) 10 *R.H.* 135, 141 (1960).

[147] See 'To the Angel of Death – The Income Tax,' *J.P.* 4/11/1966 (reporting the suicide of a factory owner who leapt to his death leaving a note which said 'Pay to the order of the Angel of Death – the income tax: the sum of my whole life'). Another income tax-related suicide (the *Olamit* case) which occurred in 1959 is described in Wilkenfeld, *Taxes*, p. 237. The fact that the system matured does not mean that evasion ceased to be a problem. See Lapidoth, *Evasion*, p. 189 (noting in 1966 that 'in spite of the extensive meas ures against evasion ... [it has] remained much more common than it is in the United Kingdom').

[148] See e.g. C.C. 486/53 (Haifa) *Attorney General v Z.S.*, reprinted in *Yedion Pnimi-Agaf Mas Hakhnasa* 67 (December 1953); C.A. 276/53 *Kahana v Attorney General*, 8 PD 404. See also Wilkenfeld, *Taxes*, p. 215 (noting the 'lack of ability on the part of the administration to prove a case against the more sophisticated tax cheaters'). Perhaps another reason was the fact that there was little incentive for tax planning due to the fact that most transactions were simply not big enough to justify the use of expensive tax advisers.

education challenge,' coming from countries where the tax authorities were seen as corrupt or were non-existent.[149]

These themes were echoed in the periodical literature of the 1960s. Thus, Boaz Nahir, a lawyer working for the Revenue, published a *Guide to Income Tax Decisions* in 1961, in which he stated that 'in other countries the courts spend a lot of time dealing with the issues of tax avoidance. In Israel there are not many cases on this issue ..., on the other hand, the cases tell of far more primitive efforts to avoid taxation, not by creating transactions whose form would lead to avoidance but by mere evasion. This, of course, is a childhood disease of a new economy suddenly required to bear a heavy burden of income taxation.'[150]

In his preface to Arye Lapidoth's 1966 comparative study of tax avoidance and evasion in Britain and Israel, Simha Gafni, Director of the State Revenue Administration in the Ministry of Finance, noted that the book 'should be especially valuable to new countries whose officials may be lacking experience in taxation matters and whose population has not yet reached the required moral standards in respect to the payment of taxes.'[151] Lapidoth himself noted in his introduction to the book that 'tax evasion which is illegal, while not uncommon in England, is widespread in Israel. Tax avoidance, which is legal, is rudimentary in Israel yet flourishes in England' and that 'taxpayers in Israel, unlike those in England, are still much more inclined to evade the tax than to resort to devices of avoidance.'[152] Lapidoth mentioned several factors in order to explain the difference. One of them was that the population of Israel was not homogeneous like that of England (which led to a relatively low standard tax compliance). Another factor was the fact that the

[149] In his report, Anderson noted that the Israeli population includes the 'widest possible range of taxpayer attitudes. It had, and has, everything form the German-Jew or English-Jew, who came to Israel as a disciplined taxpayer, through the Romanian-Jew, who had only known an ineffective and corrupt tax system, to the Oriental-Jew, who had never been exposed to income taxation at all .... Immigrants, for the most part, had little or no knowledge of the national language, and the vast majority ... brought with them a deeply ingrained attitude to the effect that "the Government is our enemy."' Anderson, *Income Tax Administration*, pp. 2–3. Of course, these ethnic stereotypes may have been quite misleading. Thus, it is interesting to note that Arye Lapidoth, quoting this passage thirteen years later, noted uneasily that 'the statement contains a correct description of the differences in the attitudes to tax of the various groups ... [but] the generalization concerning the influence of the country of origin on the different types of behavior cannot of course be more accurate than any generalization of that kind.' See Lapidoth, *Evasion*, p. 42. It seems, however, that some of the stereotypes persisted. See Azriel Kaminiski, 'Ha'alamat Misim ve-Kalkala Shkhora' (Tax Evasion and the Black Economy) 16 *R.I.M.* 359 (1987) (quoting an economic study published in 1986 which argued that the level of tax evasion in Israel was among the highest in the West and attributing this to the fact that 'Israel is a Mediterranean country in the negative sense of the word, with a problematic, disgruntled and undisciplined population').

[150] Quoted in 'Moreh Derekh le-Psikat Mas Hakhnasa' ([Book Review]: Guide to Income Tax Decisions) 15 *Sherut* 54 (May 1961).

[151] Lapidoth, *Evasion*, p. 9.

[152] *Ibid*., pp. 13, 15.

English economy was more developed than the Israeli one and that it was based on large enterprises.[153]

Justice Witkon, in a review of Lapidoth's book, seems to have accepted this proposition and connected it to his general interest in the nature of law in 'developing countries'.[154] He agreed with Lapidoth that the difference between Britain and Israel is that there is a 'basic difference between an established and developed country and a new country. In a developed country, there is usually ... a great degree of obedience to law on the one hand and of sophistication on the other. In such a country the resistance to tax will find expression in ways of avoidance which will gradually become more refined. The opposite is true of a new country. Here the sense of civic duty has not yet penetrated the consciousness of the citizenry and its heterogeneous parts, and so the emotional-moral force of the law is weak. Therefore there is no need for the effort and the advice of expensive advisors that are needed for tax planning and indeed the methods of tax evasion that have reached the Israeli courts ... are not artistic masterpieces.'[155]

Was there indeed little tax planning? This is a difficult question to answer. On the one hand, it seems reasonable to assume that there was less tax planning in the 1950s given the less developed state of the Israeli economy and the less developed state of the accounting and legal professions. One indication that this was the case can be found in the history of the Accountants Association. Since tax planning often involves the use of professional tax consultants, the growth in the number of accountants can indicate a growing interest in tax planning and indeed between 1958 and 1965 the number of accountants in Israel more than doubled from 244 to 547 accountants.[156] On the other hand, there are also indications that tax planning was prevalent in certain areas of tax law even in the 1950s.[157] Ultimately, it seems, part of the debate was not the result of actual

[153] *Ibid.*, *Evasion*, pp. 41, 200–1.

[154] Witkon, 'Ha-Mishpat be-Eretz Mitpatakhat.'

[155] Witkon, 'Bikoret Sfarim,' p. 523.

[156] Eliezer Bavli, 'Toldot Lishkat Ro'ey ha-Heshbon be-Yisrael' (The History of the Israeli Accountants Association) 15 *R.H.* 354, 358 (1965) (during this period, the population of the country grew from approximately 2,000,000 to approximately 2,500,000).

[157] A case in point is the Capital Gains from Real Estate Tax of 1949. This was a tax on capital gains from the sale of land. In order to prevent tax planning schemes based on the use of companies, the tax was levied on the sale of shares in companies whose main business was the acquisition and occupation of land. However, land owners found easy ways to bypass the tax by issuing new shares to the buyer, thus transferring ownership in the land without it being a 'sale'. This led to the incorporation of many companies whose only purpose was the avoidance of the Capital Gains from Real Estate tax. The many loopholes in the law of 1949 forced the government to replace it with new legislation in 1963. See Y. Hadari, *Mas Shevakh Mekarke'in* (Capital Gains from Real Estate Tax) (Ramat ha-Sharon: Yonatan Publishers. 1993). See also 35 D.K. 177, 178 (19/11/1963) (Finance minister Eshkol describing some of the loopholes used by Israeli taxpayers to bypass the 1949 law).

differences between 'developed' and 'developing' countries, but rather the result of commonly held perceptions of Israeli society.

IV. CONCLUSION

The history of anti-avoidance and tax interpretation doctrines in Israel in the first two decades after independence shows that explaining the development of such doctrines only by taking account of class-based factors, as Stevens has done in the English case, is too simple. Class loyalties may have played a role in influencing the attitude of the Israeli judges to tax avoidance, but other, more practical factors, such as the relative inefficiency of the tax administration mechanisms in Israel of the 1950s contributed to the adoption of a passive, formalist, pro-taxpayer approach to tax avoidance. Once the system became more efficient, the judges changed the doctrines. As is usually the case in other fields of law, the shape of judicial doctrines in tax matters, one can conclude, is effected by a host of factors, class being only one of them.

16

Tax Reform in Hong Kong in the 1970s: Sincere Failure or Successful Charade?

MICHAEL LITTLEWOOD[1]

ABSTRACT

IN THE EARLY 1970s, the British government urged the colonial Hong Kong government to scrap its strange and anachronistic tax system and establish a 'normal' income tax in its place. The colonial government duly established a Committee; and the Committee duly recommended something resembling a normal income tax. The Hong Kong government however did not implement the recommendation and has not subsequently re-examined the issue. My aim in this paper is to examine this attempt at reform; and to explain why it failed. This is worth doing because (1) the failure explains why Hong Kong still has such a peculiar tax system; (2) it was also, therefore, an important event in Hong Kong's political and economic history (though this seems generally not to be recognised); (3) it is revealing of the way in which British colonialism operated, at least in Hong Kong and perhaps elsewhere; and (4) the episode seems potentially instructive, given the subsequent successes of Hong Kong's unreformed tax system.

INTRODUCTION

Hong Kong is famous for its very low rates of tax. Also well-known are the remarkable successes of its tax system: in particular, the Hong Kong people appear relatively content with the balance of taxation and public spending;

[1] I am grateful to David Campbell, Hugh Scogin, Philip Baker, Andrew Halkyard, Yash Ghai, Winnie Chung, Ted Tyler, Peter Wesley-Smith, Carol Jones, Bernard Rudden, Mike Dowdle, John Tiley and John Avery Jones for their comments on some of the ideas expressed in this paper. I am likewise grateful to the participants at a seminar at the School of Law at the City University of Hong Kong on 25 April 2002 and to the participants at the History of Tax Law Conference at the University of Cambridge on 4 and 5 September 2002.

and the government has generally operated at a surplus and so has accumulated very substantial reserves. What is less well-known is the very peculiar structure of the territory's tax system, which was devised by representatives of its business community in 1940 (when taxes on income were first introduced in Hong Kong).[2] Their objective, which they achieved, was a tax system which worked well enough at very low rates of tax, but which made it impossible for the government to effect substantial increases in the rates of tax (unless it radically restructured the tax system first).[3] The British and Hong Kong governments both regarded the system of taxation established in 1940 as a temporary wartime measure. Their intention was to scrap it within a year or two, and establish a 'normal' income tax charged at substantially higher rates.[4]

From 1941 to 1945, Hong Kong was occupied by the Japanese; and from 1945 until 1970, the territory was a remote colonial trading post; a shambolic refugee camp; an emerging manufactory; and a bastion against the spread of communism. That the colonial government effected no basic tax reform during this period is perhaps unsurprising. By the 1970s, however, Hong Kong was emerging as an affluent modern city-state and an internationally important trading and financial centre. Britain took pride in the colony's economic success, but even the Tories were embarrassed at the parsimony of its public spending. (Later, of course, the Thatcher and Reagan governments, and others, would look on this parsimony as something to emulate; but in the 1970s Britain was embarrassed by the almost complete lack of a welfare state in a colony clearly able to afford one.)

The British government therefore urged the colonial Governor to increase public spending; to increase the rates of tax; and to effect whatever structural reforms of the tax system were necessary to these ends. In 1976, the Governor duly established a Committee (the Third Inland Revenue Ordinance Review Committee) to advise as to how this might best be done.[5]

[2] See Michael Littlewood, 'Taxation without Representation: the History of Hong Kong's Troublingly Successful Tax System' [2002] *British Tax Review* 212.

[3] For reasons explained below at note 28.

[4] By 'normal' income tax, I mean a tax on income as such. So diverse are the systems of income taxation which exist in the world, and which have existed in the past, and so divergent are the theories as to how (if at all) income *ought* to be taxed, that to suggest that there is such a thing as a 'normal' income tax is inevitably to invite argument. Moreover, Hong Kong's tax system has proved remarkably successful in several important respects. To label it abnormal might seem unreasonably pejorative. Even so, the differences between Hong Kong's tax system and most others are so basic that to refer to the rest as normal, and Hong Kong's as not, is the most practical way to proceed. This approach is justified also by the fact that it was routinely taken by those involved at the time the system was established: the senior members of the Hong Kong government and those involved at the Colonial Office in London repeatedly made the distinction between 'normal' income taxes (that is, taxes on income as such) and the system they were establishing in Hong Kong, even though British Imperial notions of normality did not necessarily hold in the rest of the world. I do not mean, by classifying Hong Kong's tax system as abnormal, any criticism of it. On the contrary, it is precisely because of its abnormal success that it is especially deserving of study.

[5] The Inland Revenue Ordinance 1947 (which established Hong Kong's peacetime system of income taxation in 1947 and remains in force still) has been formally reviewed three times.

The Committee duly recommended something resembling a 'normal' income tax.[6] But the colonial government did not adopt the recommendation, and there has been no subsequent attempt at basic tax reform in Hong Kong. Consequently, the system of taxation established in 1940 remains intact today. The attempt at reform in the 1970s is thus a crucial episode in the history of Hong Kong's tax system: until the late 1970s the Hong Kong government remained committed to the original objective of scrapping the system established in 1940 and establishing a normal income tax; since then, the existing system has been regarded as a permanent measure not requiring any structural reform.

Hong Kong's tax system plainly served the interests of the businessmen who designed it. Their motives, then, were at best dubious. Conversely, the British and colonial governments' attempts to establish a normal income tax seem to have been motivated by a genuine desire to do what they thought best for the people of Hong Kong (though both governments were clearly inclined to assume that the way things were done in Britain would usually be best for the colony). It is ironic, therefore, that the system designed by the businessmen proved remarkably successful; and that there seems to have been (and to be still) virtually no popular demand for the kind of income tax the British regarded as normal.

My aim in this paper is to examine the Hong Kong government's attempt to reform the colony's tax system in the 1970s; and to explain why it failed. In particular, I examine the possibility that the colonial government regarded the attempt as doomed from the outset; and that its real objective was not to reform the tax system at all, but merely to placate London. Although the paper concentrates on the 1970s, its aim is to use this crucial period as a lens to examine more generally the history of Hong Kong's system of income taxation from its establishment in 1940 until the present day. In particular, it seeks to explain why a supposedly-temporary system of taxation hurriedly established in 1940 remains in place today.

HONG KONG'S SYSTEM OF GOVERNMENT

It may be useful, at this point, to provide a brief account of Hong Kong's system of government, so as to make what follows more comprehensible to

See *Report of the Inland Revenue Ordinance Committee*, Government Printer, Hong Kong, 1954; *Report of the Inland Revenue Ordinance Review Committee Parts I (1967) and II (1968)*, S Young, Government Printer, Hong Kong, 1967 and 1968; and *Report of the Third Inland Revenue Ordinance Review Committee*, publisher not identified (but presumably Hong Kong Government Printer), Hong Kong, 1976. I have followed the usual practice of referring to these committees as the First, Second and Third Inland Revenue Ordinance Review Committees (and to their reports accordingly). The First and Second Review Committees were confined to considering administrative detail and not authorised to consider structural reform. See below at notes 43 and 46.

[6] *Report of the Third Inland Revenue Ordinance Review Committee*, chapter 2.

readers unfamiliar with the subject. The colonial Hong Kong government was established in accordance with the British Imperial norm in the mid-nineteenth century and remained basically unchanged almost until the territory was returned to China in 1997.[7] There was a Governor, who was appointed by and answerable to the British government, but who enjoyed very considerable latitude in the day-to-day government of the colony. There was also a Legislative Council and an Executive Council, both of which were comprised of 'official' members (senior civil servants plus the general commanding the troops stationed in the colony) and 'unofficial' members (supposedly representing the populace generally, but in fact leading businessmen). Until the mid-1980s (in other words, until after Britain had agreed to return the territory to China), there was no pretence at democracy: all the members of both councils were appointed by the Governor.

The Governor could legislate only with the approval of the Legislative Council; but since its members were appointed by him, disagreements were rare. (The colonial government's proposals to reform the colony's tax system in the 1970s were controversial; but this controversy was exceptional.) Moreover, the Governor controlled a majority (because the official members outnumbered the unofficials). The government[8] could therefore legislate at will, if need be. The Executive Council was purely advisory; it had no formal power whatever. In practice, however, the Executive Council was the more powerful body. It met in private, and functioned as a kind of cabinet (except that its unofficial members did not even pretend to accept responsibility for the government's actions). The Governor rarely disregarded the Executive Council's advice; and the Legislative Council almost always endorsed whatever the Governor and the Executive Council proposed. Thus, the government very rarely proposed legislation publicly unless it had already procured the Executive Council's approval; and once a proposal had the Executive Council's approval, it was very rare for the Legislative Council not to go along with it. Consequently, the proceedings of the Legislative Council were generally non-confrontational[9] and have been described as resembling 'the ritual of a church service'.[10] There was

[7] On Hong Kong's system of government generally, see Norman Miners, *The Government and Politics of Hong Kong*, updated 5th edn, Oxford University Press, Hong Kong, 1998; Peter Wesley-Smith, *Constitutional and Administrative Law in Hong Kong*, 2nd edn, Longman Asia, 1994; Yash Ghai, *Hong Kong's New Constitutional Order: The Resumption of Chinese Sovereignty and the Basic Law*, 2nd edn, Hong Kong University Press, Hong Kong, 1999; and Anton Cooray and others, *International Encyclopaedia of Laws:* Hong Kong, Kluwer International, The Hague 2003.

[8] In accordance with Hong Kong usage, I use the term 'government' to mean the executive.

[9] John Rear, 'One Brand of Politics', in K Hopkins, ed, *Hong Kong: The Industrial Colony*, Oxford University Press, Hong Kong, 1971; S N G Davies, 'One Brand of Politics Rekindled' (1977) 7 *Hong Kong Law Journal* 44.

[10] Rear (note 9), 85.

no debate in the normal sense, for disagreements were rare and, when they did occur, were 'normally over detail, not fundamentals'.[11]

Over the course of the latter half of the twentieth century, the Legislative Council was gradually expanded from about twelve members to about sixty. As a result, the unofficials eventually outnumbered the officials; and the Chinese outnumbered the non-Chinese. Also, in the 1980s, after Britain had agreed to return Hong Kong to China, a degree of democracy was introduced in the Legislative Council and the number of its official members was gradually reduced to zero. In 1997, Hong Kong ceased to be a British colony and became a Special Administrative Region (or 'SAR') of the People's Republic of China, but this entailed very little change in its system of government.[12] There is now a Chief Executive rather than a Governor, and he is elected by a committee dominated by Beijing-friendly businessmen rather than appointed directly by London; but the Executive and Legislative Councils remain much as before (though the Legislative Council has reverted to a less democratic form than in the last few years under British rule). The Executive Council is still appointed by the Chief Executive; it still meets in private; and its function appears unchanged.[13] The Legislative Council is still partly democratic and both councils are still dominated by the representatives of business. Peculiarly, then, the only substantially populated place in the world whose government is still based on the British colonial model is Hong Kong – a small corner of an emerging superpower whose central government still operates along Leninist lines.

THE HISTORY OF HONG KONG'S TAX SYSTEM FROM 1940 TO 1971

To explain the attempts to reform Hong Kong's tax system in the 1970s, it is necessary first to review the system's earlier development. Prior to 1940, there were no taxes on income in Hong Kong. But in 1939, within weeks of war breaking out between Britain and Germany, the Hong Kong government proposed to establish in the colony a tax on incomes for the purpose of funding 'gifts' to Britain in support of the war effort.[14] Its proposal was

[11] Davies (note 9), 47.
[12] Since 1 July 1997, Hong Kong's constitution has been contained in an instrument called the Basic Law, which is itself subordinate to the Chinese constitution. See Ghai (note 7) and Cooray and others (note 7). Prior to that date, the colony's constitution was based on Letters Patent and Royal Instructions issued by the British government in the name of the Crown. The Basic Law contains notable Buchananite limitations on the government's authority to levy taxes. See Michael Littlewood, 'The Taxing and Spending Powers' in Cooray and others (note 7).
[13] On 1 July 2002, the SAR government established a 'ministerial' system of government, in which the official members of the Executive Council are political appointees rather than civil servants (though many of those subsequently appointed are in fact the same people). The significance of this reform remains to be seen.
[14] For a more detailed account of the early history of Hong Kong's tax system, see Littlewood (note 2).

for a 'normal' income tax, by which it meant a tax on persons resident in the colony on their worldwide incomes (that is, both Hong Kong income and offshore income) and also on income derived from the colony by persons resident elsewhere.[15] As one would expect, the proposal was opposed by the business community, in whose interest the colony was governed. Chinese businessmen, in particular, were incensed, because they were unaccustomed to income tax and regarded it as an inquisitorial affront to Chinese custom. Perhaps, too, they were less interested in the outcome of the war in Europe; and more concerned about the fate of China (at that time suffering from both the Japanese occupation of much of the country and the civil war between the Kuomintang and the Communists).

The colonial constitution, as I have explained, would have permitted the government to legislate regardless. This, however, was considered 'out of the question',[16] especially since the revenues raised by the proposed tax were intended not to be spent for the colony's own direct benefit, but to be transferred to Britain.[17] The impasse was resolved by the establishment of a Committee, comprised mainly of colonial civil servants and leading businessmen.[18] By this means a deal was done by which the representatives of business agreed to support the establishment of a system of income tax; and the government agreed to abdicate the design of it to them.

The product of this process was the War Revenue Ordinance 1940.[19] This established a peculiar system of taxation which was copied from that in force in the United Kingdom in the *nineteenth* century and which differed from the government's original proposal in two basic respects. First, there was no tax on income, as such, at all. Instead, there was a schedular system of three separate taxes on three different kinds of income: profits tax was charged on the profits of business;[20] salaries tax was charged on income from employment (and on analogous income, such as

[15] See note 4.
[16] G E J (later Sir Edward) Gent (of the Colonial Office), memorandum, 2 November 1939, CO129/582/7, 35. (The series of files labelled 'CO129' at the British Public Record Office at Kew hold the correspondence between the governors of Hong Kong and the Colonial Office, together with various related materials.)
[17] The British government's sensitivity in this regard can perhaps be traced to the American War of Independence, which was in part a response to the levying of British taxes in the American colonies.
[18] *Report of the War Revenue Committee*, Hong Kong sessional paper No 1, 1940, Noronha & Co, Hong Kong Government Printer.
[19] Pieces of primary legislation in colonial Hong Kong were called ordinances, not acts. This appears to have been the usual practice in British colonies not possessing responsible government. The same practice has been followed since 1 July 1997, when China resumed the exercise of sovereignty over the territory.
[20] Profits tax was of two kinds. Corporations were charged 'corporation profits tax' and unincorporated firms were charged 'business profits tax': War Revenue Ordinance 1940 Chapter IV (sections 13–26). Dividends (like distributions of the profits of unincorporated firms) were not taxed (on the basis that a dividend was a payment out of a fund which had already borne tax). Capital gains were exempt.

directors' fees);[21] and property tax was charged on the rental value of property.[22] Secondly, the system was 'based on the source principle', meaning that only income derived from Hong Kong was taxable. Offshore income, in other words, was exempt from tax.[23] The maximum rate of tax was 10%.[24] But the allowances were set so high, and the average income in Hong Kong at that time was so low, that less than 1% of the populace were liable to pay any tax at all.

The ostensible advantage of the schedular system devised by the businessmen was that, unlike a normal income tax, it did not require taxpayers to divulge their total incomes (because income of different kinds was taxed separately).[25] It was thus less invasive of their privacy – a point on which, as I have mentioned, the colony's Chinese populace claimed a particular cultural sensitivity.[26] But the schedular system also had another feature which was not mentioned at the time, but which was presumably its real attraction to the businessmen who designed it. This was that, whilst it was capable of working well enough at very low rates of tax, it was not capable of supporting high or even moderate rates of tax.[27] The reason for this, in turn, was that a schedular system of separate taxes on different kinds of income is 'inherently inequitable';[28] and, whilst the inequity was tolerable

[21] War Revenue Ordinance 1940 Chapter III (sections 8–12).

[22] War Revenue Ordinance 1940 Chapter II (sections 5–7). Property tax was initially imposed not on actual rents but on the notional rental value of property (that is, land, buildings and parts of buildings). Subsequently these provisions were amended so as to impose property tax on landlords' actual rental receipts. See, now, Inland Revenue Ordinance 1947 (as amended) sections 5 and 5B.

[23] War Revenue Ordinance 1940 sections 5, 8, 13 and 14. In the late nineteenth century and the early twentieth, most British colonial income taxes were based on the source principle; that is, they exempted offshore income from tax. By 1940, however, when taxes on income were introduced in Hong Kong, this approach had fallen out of favour elsewhere. Instead, by 1940, most colonial and dominion income taxes (like Britain's own income tax) covered the worldwide income (that is, both domestic and offshore income) of persons resident in the taxing jurisdiction and also income derived from that jurisdiction by persons resident elsewhere.

[24] War Revenue Ordinance 1940 sections 5, 8, 13 and 14.

[25] *Report of the War Revenue Committee* (note 18).

[26] See for example *Hong Kong Hansard*, 9 and 16 November 1939.

[27] Hong Kong's tax system thus provides a case study of a type of fiscal constitutionalism: see, for example, Geoffrey Brennan and James M. Buchanan, *The Power to Tax: Analytical Foundations of a Fiscal Constitution*, Cambridge University Press, Cambridge, 1980.

[28] Hong Kong's tax system was first described as 'inherently inequitable' in 1940. See CO129/586/8. But the description encapsulates a truth so fundamentally important that it has been frequently repeated since. The reason for the inequity is that, if different categories of income are taxed separately at progressive rates, a person whose income falls exclusively into a single category will be required to pay more tax than one whose total income is the same, but is split among several categories. The point is most conveniently illustrated by means of a simplified hypothetical case. Suppose, for example, two tax systems. System A is a normal income tax, charged at 50% on all income over \$100,000. System B consists of two separate taxes, one (called profits tax) on business profits and the other (called property tax) on rental income. Profits tax and property tax are both charged at 50% on all relevant income (that is, profits and rents respectively) over \$100,000. Now assume two people, Jack and Jill. Each has a total income of \$200,000. Jack's \$200,000 consists entirely of profits. Jill's \$200,000 consists of

at very low rates of tax, substantial increases in the rates of tax would have accentuated the inequity and resulted in intolerable administrative difficulty. The government therefore could not effect substantial increases in the rates of tax, unless it radically restructured the system first.[29] Thus the business community, although conceding the establishment of taxes on income, had effectively created, in the peculiar schedular structure of the War Revenue Ordinance, an extra line of defence against the possibility of higher taxes.[30]

The War Revenue Ordinance 1940 proved even less satisfactory than the government had anticipated (largely because its drafting was sabotaged by the representatives of business). A year later, it was repealed and replaced by the War Revenue Ordinance 1941. The new legislation left the original system basically intact, but to the original three taxes added a fourth, on interest. It was called, of course, interest tax.[31] The War Revenue Ordinance 1941 also increased the rates of tax (the new maximum being 14%);[32] tightened the drafting; and effected a range of other minor reforms. But on 7 December 1941 the Japanese attacked Pearl Harbour and, more or less simultaneously, Hong Kong. On Christmas day the British colonial government surrendered, and its administration of the colony's tax system was temporarily suspended.

profits of $100,000 and rents of $100,000. Under tax system A, Jack and Jill are both liable for $50,000 in tax. (The first $100,000 is exempt; and the second $100,000 is taxed at 50%; $100,000 x 50% = $50,000.) Under system B, Jack's liability is exactly the same; he is liable for $50,000, as before. The first $100,000 of his income is exempt, as before; and the second $100,000 is chargeable to tax (that is, profits tax) at 50%, as before. Jill, however, is not liable for any tax at all under system B. Her $100,000 in profits is entirely exempt, because profits tax is charged only on profits above $100,000. And her rental income is similarly exempt, because property tax is similarly imposed only on rents in excess of $100,000. Thus, while Jack pays tax at an effective rate of 25% ($50,000 out of $200,000), Jill pays none, even though their total incomes are the same. It is commonly thought that Hong Kong's tax system, as established by the War Revenue Ordinances of 1940 and 1941 and preserved by the Inland Revenue Ordinance 1947, is not only horizontally but vertically inequitable. But vertical equity is essentially a matter of opinion (whereas horizontal equity seems to be objectively identifiable).

[29] Whether the administrative difficulty would really have been intolerable was, of course, never put to the test. But the British government and the colonial government believed that the administrative and political costs of increasing the rates of tax without restructuring the system would be too high to bear.

[30] Equally, Britain's own tax system was thought to be structurally incapable of supporting high rates of tax until the concept of 'total income' was introduced in the wake of David Lloyd George's 1909 'War Budget on Poverty'. For the history of the British tax system, see Basil Sabine, *A History of Income Tax*, George Allen and Unwin, London, 1966; Basil Sabine, *A Short History of Taxation*, Butterworths, London, 1980; Stephen Dowell, *History of Taxation and Taxes in England*, Longmans Green, London, 1884, republished Frank Cass & Co, London, 1965; Sven Steinmo, *Taxation and Democracy: Swedish, British and American Approaches to Financing the Modern State*, Yale University Press, New Haven, 1993; and Martin Daunton, *Trusting Leviathan: The Politics of Taxation in Britain 1799–1914*, Cambridge University Press, Cambridge, 2001 and *Just Taxes: The Politics of Taxation in Britain 1914–1979*, Cambridge University Press, Cambridge, 2002.

[31] War Revenue Ordinance 1941 Chapter V (sections 30–35).

[32] War Revenue Ordinance 1941 sections 5, 14, 15, 16 and 30.

In 1945, British rule was restored. The British and Hong Kong governments both regarded it as obvious (1) that the colony required a peacetime income tax; (2) that the schedular system devised during the war would not suffice; and (3) that the rates of tax should be comparable to those in Britain. In 1946, therefore, the Hong Kong government proposed the establishment of a 'normal' income tax as a permanent measure.[33] The business community, of course, was opposed. Most Chinese businessmen remained vehemently opposed to a permanent income tax in any form. The expatriate businessmen suggested, as a compromise, the resurrection of the schedular system devised during the war. The colonial government reluctantly agreed to this, but only as a temporary measure pending the establishment of a normal income tax. London, too, gave its reluctant blessing. Like the colonial government, however, the Colonial Office emphasised that the anachronistic schedular system was acceptable as a temporary measure only; that it must be scrapped as soon as possible and a normal income tax established in its place; and that in the meantime the rates of tax must be 'as high as possible'.[34]

The outcome was the Inland Revenue Ordinance 1947, which was closely based on the War Revenue Ordinance 1941 and preserved its basic structure. Thus, as before, there was no tax on income as such; instead, there were separate taxes on profits, salaries, rents and interest;[35] and, as before, income derived from outside Hong Kong went untaxed.[36] The 'standard rate' of tax was 10%.[37] This standard rate was effectively the maximum rate (as against both governments' plans for a maximum rate of at least 50%) and, as before, the allowances were set at levels that entirely exempted 99% of the population from tax.[38]

Although preserving the schedular structure, the Inland Revenue Ordinance 1947 introduced an important new twist: to the separate taxes on profits, salaries, rents and interest there was added what was called 'personal assessment'.[39] This was, essentially, a 'normal' income tax – but a voluntary

[33] Sir Geoffrey Follows (Hong Kong's Financial Secretary from 1946 to 1951), *Hong Kong Hansard*, 25 July 1946, 72. In the British colonial system, the Financial Secretary was (and is) roughly equivalent to the Chancellor of the Exchequer in the United Kingdom or the Secretary of the Treasury in the United States.

[34] Arthur Creech Jones (Secretary of State for the Colonies), telegram to Sir Mark Young (Governor of Hong Kong), 26 January 1947, CO129/595/3, 11.

[35] Inland Revenue Ordinance 1947 Chapters II, III, IV and V.

[36] Inland Revenue Ordinance 1947 sections 6, 9, 15, 16 and 29.

[37] Inland Revenue Ordinance 1947 section 5.

[38] Inland Revenue Ordinance 1947 sections 13 and 43. Profits tax and interest tax were charged at the flat 'standard rate' of 10% from the first dollar without the benefit of any allowances: Inland Revenue Ordinance 1947 sections 5, 15, 16 and 29. Property tax was charged at 5%, also from the first dollar without allowances: Inland Revenue Ordinance 1947 section 6. Unlike the other taxes, salaries tax incorporated a system of allowances which exempted the first part of the taxpayer's income from tax. The rest was charged at progressive rates ranging from 2.5% to 20%. Total liability, however, was limited to a flat 10% without the benefit of allowances: Inland Revenue Ordinance 1947 sections 14 and 43.

[39] Inland Revenue Ordinance 1947 Chapter VII (sections 42–44).

one, to which taxpayers could choose to submit themselves, if they wished, instead of paying the separate taxes on the several components of their incomes. Personal assessment tax was so structured as commonly to produce a lower total liability to tax than the schedular taxes.[40] The government's plan was thus to entice taxpayers to elect personal assessment – that is, to subject themselves voluntarily to a normal income tax. Then, it was thought, it would be possible to scrap the schedular taxes. What would be left would be a *compulsory* single tax on income generally, except for offshore income – in other words, an income tax which would exempt offshore income but would be otherwise normal.[41] As will be seen, however, the plan failed.

The British and Hong Kong governments both intended that the Inland Revenue Ordinance should remain in force for only a year or two pending the establishment of a normal income tax. By the time it had been passed into law, however, it had already become apparent that the establishment of a normal income tax might take longer than the administration had expected. In 1950, the standard rate of tax was increased from 10% to 12.5%,[42] but the structure of the system remained unchanged. In 1952 the then Governor, Sir Alexander Grantham, established a Committee (the First Inland Revenue Ordinance Review Committee) to review the Inland Revenue Ordinance.[43] It was chaired by the Financial Secretary, Sir Arthur Clarke, who regarded the establishment of a normal income tax as an obvious necessity. It seems probable that Clarke initially intended the Committee to recommend the scrapping of the schedular system and the establishment of a normal income tax in its place – and so to facilitate the achievement of that objective. If so, he was stymied at the outset: the Committee's terms of reference (presumably framed under the influence of colonial business interests) did not permit it to consider the possibility of structural reform. Consequently, it was reduced to proposing comparatively trivial refinements (though it also strayed beyond its authority to endorse the view that the colony's tax system was 'inherently inequitable').[44]

Clarke retired in 1961 and was succeeded by Sir John Cowperthwaite. Like Clarke, he regarded the establishment of a normal income tax as

[40] Personal assessment tax was charged at the same progressive rates as salaries tax. See note 38. The structure of the Inland Revenue Ordinance and the rates at which the several taxes for which it provided were charged meant that generally (1) small incomes (meaning those of the entire populace bar the richest 1 or 2 per cent) were exempt; (2) middle-class incomes were taxed at progressive rates (under salaries tax or personal assessment); and (3) large incomes were taxed at flat (that is, proportional) rates (under the schedular taxes or personal assessment, depending on the circumstances).

[41] E W Pudney (the principal draftsman of the Inland Revenue Ordinance 1947 and then Hong Kong's first Commissioner of Inland Revenue), memorandum, 8 January 1947, CO129/595/3, 29.

[42] Inland Revenue (Amendment) Ordinance 1950 section 2.

[43] See *Report of the First Inland Revenue Ordinance Review Committee* (note 5).

[44] *Report of the First Inland Revenue Ordinance Review Committee* (note 5), 1; see also note 28.

an obvious necessity. Also like Clarke, however, he failed to establish one. In 1966, the standard rate of tax was again increased, from 12.5% to 15%;[45] but again the system's schedular structure remained unchanged. Also in 1966 the Governor, Sir David Trench, established another Committee (the Second Inland Revenue Ordinance Review Committee) to review the colony's system of income taxation.[46] Again, however, the Committee's terms of reference seem clearly to have been drafted with a view to reining in the reforming instincts of the Financial Secretary: it was authorised to consider 'any proposal which could be embodied in the Inland Revenue Ordinance that would not require the alteration of its basic structure'.[47] Thus the Second Committee, like the First, was reduced to minor tinkering (though it, too, like the First Review Committee, endorsed the view that the colony's tax system was 'inherently inequitable').[48]

THE 1970s IN HONG KONG

By 1971, Hong Kong had already become, according to the colonial government, 'a stable and increasingly affluent society comparable with the developed world in nearly every way.'[49] But it was really in the course of the 1970s that the colony was transformed from a comparatively unimportant remnant of empire into the rich modern city-state and internationally important trading and financial centre it is today. For example, it was only in 1975 that the Hong Kong Cricket Club was obliged to surrender its pitch in Central (as the territory's central business district is called) and move to a more appropriate venue. As Frank Welsh (the author of the best general history of Hong Kong) puts it, 'a new Hong Kong has emerged since 1972, changed to a degree that makes the colony of that time almost unrecognisable.'[50] The spectacular economic growth which had begun in 1945 continued throughout the decade. GDP rose from $19 billion in 1970 to $106 billion in 1980;[51] per capita GDP increased from $4,853 in 1970 to $20,933 in 1980.[52]

[45] Inland Revenue (Amendment) Ordinance 1966 section 4.
[46] See *Report of the Second Inland Revenue Ordinance Review Committee* (note 5).
[47] *Report of the Second Inland Revenue Ordinance Review Committee (Part I)* (note 5), page iii.
[48] *Report of the Second Inland Revenue Ordinance Review Committee (Part II)* (note 5), paragraph 8.
[49] Hong Kong Government, *Hong Kong Annual Review 1971*, Hong Kong Government Printer, Hong Kong, 1971, 2.
[50] Frank Welsh, *A History of Hong Kong*, revised edition, Harper Collins, London, 1997, 475.
[51] Sir Philip Haddon-Cave, 1981 Budget Speech, Table 1, *Hong Kong Hansard*, 25 February 1981, 542. At constant (1973) prices, GDP rose from $25 billion in 1970 to $60 billion in 1980: Sir Philip Haddon-Cave, 1981 Budget Speech, Table 2, *Hong Kong Hansard*, 25 February 1981, 544.
[52] Sir Philip Haddon-Cave, 1981 Budget Speech, Table 1, *Hong Kong Hansard*, 25 February 1981, 542. At constant (1973) prices, per capita GDP rose from $6,135 in 1970 to $11,757 in 1980: Sir Philip Haddon-Cave, 1981 Budget Speech, Table 2, *Hong Kong Hansard*, 25 February 1981, 544.

The two key figures in the colonial administration in the 1970s were Sir Murray Maclehose (who served as Governor from 1971 to 1981) and Sir Philip Haddon-Cave (who served as Financial Secretary from 1971 to 1981). Maclehose had made his career not in the Colonial Office, but in the Foreign Office. His appointment marked a departure from tradition and signified not only the demise of the Colonial Office (the remnants of which were taken over by the Foreign Office in 1968), but also that the British government was less concerned with the administration of Hong Kong than with Britain's own relationship with China. The appointment of a Governor with a Foreign Office background was intended to ensure a sound appreciation of these priorities. Also, to the extent that the British government cared about Hong Kong at all,[53] it was becoming increasingly embarrassed about the anachronistic manner in which the colony was still governed.[54] It was not proposed to go so far as to democratise the government, but it was intended that the substance of its policies should no longer be quite so remote from what would have been acceptable in Britain. A reforming governor was therefore required, and it seems to have been thought that Maclehose would meet the need more satisfactorily than an appointee with a Colonial Office background.

Maclehose and Haddon-Cave oversaw an enormous expansion of the colonial government. Public spending on education rose from $596 million in 1971 to $3.7 billion in 1981. Over the same period, public spending on housing rose from $218 million to $4.8 billion. Total government spending increased from $3 billion to $26 billion.[55] The public sector grew from 13% of the economy in 1971 to 22% of a much larger economy in 1981.[56] And of course it fell to the Financial Secretary to oversee this expansion, and to find the money to pay for it.

HADDON-CAVE'S VIEWS ON TAX REFORM

Like his predecessors, Haddon-Cave regarded the Inland Revenue Ordinance as fundamentally inadequate, and his reasoning was much the same as theirs. First, Haddon-Cave shared his predecessors' concerns as to

[53] The British government took a fairly keen interest in Hong Kong from 1945 (when it reasserted its position after the Japanese occupation) until about 1950 and again from the late 1970s (when preparations for the handover commenced) until 1 July 1997 (when Britain's responsibility for the territory came finally to an end). But from about 1950 until the late 1970s, Britain took little interest in the colony. As Welsh (note 50, 454) puts it, the British government's position on Hong Kong during this period was one of 'benign neglect'.

[54] Welsh (note 50), chapters 15 and 16.

[55] Sir Philip Haddon-Cave, 1981 Budget Speech, Table 12, *Hong Kong Hansard*, 25 February 1981, 566–567.

[56] Sir Philip Haddon-Cave, 1981 Budget Speech, Table 9, *Hong Kong Hansard*, 25 February 1981, 558–559.

both the inherent inequity of the schedular system and the obstacle it posed to the imposition of progressive rates of tax on high incomes. Like them, therefore, he wanted to scrap the schedular system and establish in its place a 'normal' income tax (that is, a single tax on income as such). Secondly, Haddon-Cave was concerned at the exemption from tax of profits derived from outside Hong Kong, and the scope for abuse which it afforded. He did not go so far as to propose scrapping the exemption altogether (let alone taxing offshore income of kinds other than profits), but he did propose to restrict its scope so as to prevent erosion and abuse. He proposed also to establish a withholding tax on dividends. These were his three main objectives, and it was (ostensibly, at least) mainly to achieve them that the Third Review Committee was established. Ultimately, however, the project failed on all three counts: the system's basic schedular structure remained intact; the exemption of offshore profits (and offshore income of other kinds) remained as broad as before; and the plan to introduce a tax on dividends was abandoned. In all three respects, the Inland Revenue Ordinance remains unchanged today.

HADDON-CAVE AND THE EXEMPTION FROM TAX OF OFFSHORE INCOME

In his 1973 Budget Speech, Haddon-Cave announced that he intended to extend (or, as he put it, 'restore') the territorial scope of profits tax.[57] 'Court decisions have shown', he complained, 'that a business in Hong Kong doing exactly what it was set up to do in Hong Kong and nowhere else can have business income derived from outside Hong Kong, coming from no conduct of business outside Hong Kong, and escaping charge.'[58] The Financial Secretary announced that he planned to amend the Ordinance so as to rectify this deficiency, and concluded with the hope that

[57] Although Haddon-Cave maintained that he wanted to *restore* the scope of profits tax, it is more accurate to describe his proposal as *extending* it (because it had never previously had the scope he wished to give it). His misdescription had an obvious tactical advantage (because extending a tax is typically more difficult than restoring its scope to combat erosion and avoidance); but whether it was deliberate is difficult to say (because it might have been based on a genuine misunderstanding of the legislation's history).

[58] *Hong Kong Hansard*, 28 February 1973, 497. Presumably the decisions he had in mind were *Commissioner of Inland Revenue v The Hong Kong and Whampoa Dock Co Ltd* (1960) 1 HKTC 85 and *Commissioner of Inland Revenue v International Wood Products Ltd* (1971) 1 HKTC 551 (for these are the only reported cases which fit his description). But in 1938, in *Commissioner of Income Tax, Bombay Presidency and Aden v Chunilal B Mehta of Bombay* (1938) LR 65 IA 332, the Privy Council had held (two years before taxes on income were introduced in Hong Kong) that a firm without a permanent establishment outside the taxing jurisdiction can, nonetheless, derive profit from outside that jurisdiction. That this decision is authoritative in Hong Kong was confirmed more than half a century later by the Privy Council itself in *Commissioner of Inland Revenue v Hang Seng Bank Ltd* [1991] 1 AC 306.

the amending legislation would come into effect on 1 April 1974.[59] Its effect would be to extend profits tax to cover all the profits made by a business carried on in Hong Kong except those attributable to a permanent establishment elsewhere.[60]

A year later, however, nothing had happened. Legislation had not even been gazetted, let alone come into force. Haddon-Cave offered no explanation for the delay but, in his 1974 Budget Speech, he repeated that he intended to legislate to 'restore' profits tax to its original geographical scope. He now planned, he said, that the legislation would come into effect on 1 April 1975.[61]

Another year went by however and, again, nothing happened. In his 1975 Budget Speech, Haddon-Cave again referred to the proposal announced in 1973 and repeated in 1974 to 'restore' the scope of profits tax. A Bill had in fact been drafted, he said, which solved the problem in accordance with his earlier announcements but 'without in any way offending the spirit of the territorial source criterion.'[62] By this he meant, presumably,[63] that the amendments would bring to tax all the profits of a business carried on in Hong Kong except those, if any, properly attributable to branches elsewhere. 'But', he concluded abruptly, 'it has been decided not to proceed with this bill and for the time being there the matter must rest.'[64] By whom this had been decided, Haddon-Cave did not say. Nor did he explain why. But the explanation is, presumably, the obvious one: business interests were opposed to the proposed amendments and must have persuaded the government to abandon them.[65] Thus, Haddon-Cave's proposal to 'restore' the Ordinance's territorial scope had not yet come to anything when the Third Review Committee was established in 1976. Consequently, this specific proposal was subsumed by the more general review conducted by the Committee.

THE PROPOSAL TO TAX DIVIDENDS

It was also in the course of his 1975 Budget Speech that Haddon-Cave first announced the government's intention to introduce a tax on dividends.[66]

[59] *Hong Kong Hansard*, 28 February 1973, 497.
[60] *Hong Kong Hansard*, 27 February 1974, 604.
[61] *Ibid*.
[62] 1975 Budget Speech, paragraph 187, *Hong Kong Hansard*, 26 February 1975, 524.
[63] This Bill was never gazetted and no copy of it seems to have survived.
[64] 1975 Budget Speech, paragraph 187, *Hong Kong Hansard*, 26 February 1975, 524.
[65] I have found no direct evidence of such persuasion; but this is not surprising, for neither the government nor the businessmen would have been likely to acknowledge it publicly. It is possible that evidence exists in the correspondence between the Maclehose and London; or in other records preserved by either the British government or the Hong Kong government; but neither government has yet made records from this period publicly accessible.
[66] As I have mentioned, dividends were not taxed under the War Revenue Ordinances or the Inland Revenue Ordinance. Profits were taxed; and dividends were treated as payments out of

The new tax, he explained, would come into effect on 1 April 1976 and would be charged on all dividends paid by companies resident in Hong Kong.[67] He did not commit himself to the rate at which it would be charged, but suggested that it might be in the region of 3.5%. The tax would be collected from the company, not its shareholders. That is, any Hong Kong-resident company paying a dividend would be obliged to withhold the amount of the tax due on it and to account for this to the Revenue.[68] The tax withheld would constitute the shareholder's final liability; it would not be subject to subsequent adjustment, either upwards or downwards, to take account of the recipient's total income or other circumstances. To prevent companies from avoiding the new tax by retaining their profits and not declaring dividends, it would be complemented by a tax on undistributed profits, to be called undistributed profits tax. A certain percentage of profits would be permitted to be retained without attracting this tax, but this percentage the Financial Secretary left at this stage unspecified. Nor did he specify the rate at which undistributed profits tax would be charged.

It would be impossible, said Haddon-Cave, to introduce the new taxes immediately, because it would take time to draft the legislation; and it would therefore be necessary, he continued, to find 'some simple way of bridging the interval'.[69] For this purpose, he announced, the rate at which companies were charged profits tax would be increased by 1.5% (that is, from the standard rate of 15% to 16.5%). The effect of this increase, he said, would approximate that of the two new taxes; and its purpose was to serve as an interim measure, to achieve that effect, until the new taxes were introduced on 1 April 1976. At that point, it would be repealed as regards resident companies, which would again pay profits tax at the standard rate. But non-resident companies carrying on business in Hong Kong would continue to be charged profits tax at the increased rate, since their dividends would not be chargeable to dividend withholding tax.

Haddon-Cave was 'sure', he said, that 'because of its modest and reasonable nature' the proposed tax on dividends would 'receive the support' of the unofficial members of the Legislative Council.[70] But, of course, it did not.

a taxed fund. This meant, however, that dividends paid out of untaxed profits (for example, capital gains or offshore profits) went entirely untaxed. It is one of the notable advantages of very low rates of tax (such as Hong Kong's) that the corporate rate can sensibly be higher than the maximum personal rate – thus eliminating the difficulties presented by the taxation of corporate profits and dividends which arise at higher rates of tax.

[67] The dividend withholding tax would be charged on all dividends, irrespective of whether the profits out of which they were paid were themselves taxable. Dividends paid out of offshore profits or capital gains (neither of which was taxable) would therefore be taxable.

[68] Sir Philip Haddon-Cave, 1975 Budget Speech, paragraphs 90–94 and 190 and Appendix 6, *Hong Kong Hansard*, 26 February 1975, 494–495, 524–525, 533–534.

[69] 1975 Budget Speech, paragraph 91, *Hong Kong Hansard*, 26 February 1975, 494.

[70] 1975 Budget Speech, paragraph 190, *Hong Kong Hansard*, 26 February 1975, 524.

In the debate which followed Haddon-Cave's speech, very little was said about the proposal to tax dividends.[71] Perhaps this lulled him, and the government, into a false sense of optimism. 'I have made out a case for this tax [on dividends]', he said, in concluding the debate, 'which honourable members have not seriously challenged.'[72] This was true. But their silence did not signify consent, as was shortly to become apparent.

The 1.5% increase in the rate of profits tax payable by companies was duly introduced to take effect from 1 April 1975, as Haddon-Cave had said it would be.[73] But as for the tax on dividends itself, Haddon-Cave made little progress. A Bill was drafted in accordance with the proposal he had outlined in his 1975 Budget Speech, and providing also for those aspects of the proposal to which he had not then committed himself. Most importantly, the rate of the new withholding tax on dividends was confirmed at 3.5%; the part of a company's profits which it could retain without suffering the accompanying undistributed profits tax was fixed at 50%; and the rate at which this latter tax would be levied was fixed at 7%.[74]

As was often done in colonial Hong Kong, the government circulated the unpublished bill among the Legislative Council's unofficial members with a view to procuring agreement on its substance before gazetting it. But the unofficials were so resolutely opposed 'to the very concept of a tax on dividends'[75] that no compromise was possible, and so the Bill was never gazetted. Despite the opposition, Haddon-Cave was not yet ready to abandon his proposal to tax dividends. 'I remain convinced', he said, 'of the case for a tax on dividends and am personally of the view that the criticisms of the proposal have been either misdirected or irrelevant or both.'[76] Whether this was so is impossible to say, because much of the criticism was delivered

[71] Some months later, Haddon-Cave delivered a speech to the Hong Kong Rotary Club in which he repeated and expanded upon his proposal for a tax on dividends: 'Clearing up Shibboleths and Misconceptions', *South China Morning Post* (hereafter '*SCMP*'), 13 August 1975. This prompted a negative response in the colony's newspapers: H G King, 'The Case Against a Dividend Tax', *SCMP*, 22 August 1975; 'Dividend Tax Comes under Sharp Attack', *SCMP*, 18 November 1975; 'Firms Could Pull Out with Dividends Tax, Says Boyer', *The Star*, 28 February 1976. One newspaper reported: 'An ominous silence has fallen on the subject of the proposed dividend tax . . . .The public silence should not of course be misinterpreted as apathy, because a good deal of private infighting has taken place in recent months and the Financial Secretary has found his proposal under spirited attack from a variety of sources . . . .': *SCMP*, 13 November 1975. By 'private infighting' the writer presumably meant private, off-the-record attempts by leading businessmen to persuade the Governor, the Financial Secretary and perhaps other senior members of the colonial administration to abandon the proposal to tax dividends. The influence of business interests in Hong Kong of course was (and remains) notorious. See for example Miners (note 7).

[72] *Hong Kong Hansard*, 3 April 1975, 697.

[73] Inland Revenue Ordinance 1947 section 14, as amended by Inland Revenue (Amendment) (No 2) Ordinance 1975 section 3.

[74] Sir Philip Haddon-Cave, 1976 Budget Speech, paragraphs 173–176, *Hong Kong Hansard*, 26 February 1976, 552–553.

[75] 1976 Budget Speech, paragraph 175, *Hong Kong Hansard*, 25 February 1976, 553.

[76] 1976 Budget Speech, paragraph 175, *Hong Kong Hansard*, 25 February 1976, 553.

in private and never made public. At this point, however, the dividend withholding tax suffered much the same fate as Haddon-Cave's proposal to 'restore' the geographical scope of profits tax – it was overtaken by the establishment of the Third Review Committee.

THE THIRD REVIEW COMMITTEE

It was also in the course of his 1975 Budget Speech that Haddon-Cave first proposed the establishment of the Third Inland Revenue Ordinance Review Committee. The proposal was partly motivated by the state of the public finances: the government's projections of expenditure and revenue (assuming an unchanged Inland Revenue Ordinance) for the following three years produced substantial deficits, a situation Haddon-Cave described as 'clearly quite unacceptable'.[77] It would therefore be necessary, he said, to reform the tax system to produce the extra revenue required.[78] Haddon-Cave went on to say that he had 'serious reservations about the basic structure of the Ordinance' and therefore intended to establish a Committee to review it.[79] He referred to the First and Second Review Committees, both of which had regarded the Ordinance as 'inherently inequitable' but had considered themselves unable to suggest changes within their terms of reference.[80] In contrast, the Third Review Committee's terms of reference would be 'so drafted as to make it clear that the Committee will be concerned with basic principles rather than administrative details.'[81]

Haddon-Cave was quite open about the sorts of reform he thought necessary. He mentioned 'the absence of any progression in the rates of tax at the higher income levels';[82] and he mooted the possibility of 'imposing some form of surcharge' on high incomes,[83] but noted the difficulties of doing this so long as the system remained schedular:

> One of the features of the Inland Revenue Ordinance, which contrasts with the tax legislation of other countries, is that the rates of tax imposed are progressive only at the lower levels and thereafter become proportional rather than progressive.[84] I would not accept that steep progression encountered elsewhere is appropriate to the circumstances of Hong Kong. But, measured against the taxpayer's ability to pay, it is difficult to defend a system which

[77] 1975 Budget Speech, paragraph 183, *Hong Kong Hansard*, 26 February 1975, 521.
[78] 1975 Budget Speech, paragraph 186, *Hong Kong Hansard*, 26 February 1975, 523.
[79] 1975 Budget Speech, paragraphs 187–189, *Hong Kong Hansard*, 26 February 1975, 524.
[80] See above at notes 43 and 46.
[81] Sir Philip Haddon-Cave, 1975 Budget Speech, paragraph 188, *Hong Kong Hansard*, 26 February 1975, 524.
[82] 1975 Budget Speech, paragraph 188, *Hong Kong Hansard*, 26 February 1975, 524.
[83] 1975 Budget Speech, paragraph 89, *Hong Kong Hansard*, 26 February 1975, 493.
[84] See note 40.

> can result in a taxpayer with an income of $70,000 suffering the same rate of tax as one with an income of, say, $7 million. I have given serious thought to ways of imposing some form of surcharge on high level salaries, profits and property incomes. However, the basic structure of the Ordinance, that is to say, the absence of a charge on total income and the existence of a system of separate charges on different types of income,[85] coupled with the option to claim personal assessment,[86] simply does not lend itself to the imposition of such a surcharge.[87]

Haddon-Cave would have liked Maclehose to establish the Committee immediately, he said, but unfortunately, he went on, it would not be possible for it to begin its work until 1976 because the Inland Revenue Department would until then be 'more than fully occupied in the implementation of recent legislative changes as well as those which this speech anticipates.'[88] This excuse was manifestly lame: that the Department was busy might have been a reason to delay the implementation of reform, but hardly justified the postponement of the formulation of policy. Perhaps it can be inferred that the real reason for the delay was disagreement between the government and the representatives of business as to the scope of the proposed Committee's inquiry.

In any event, a year went by without the Committee being appointed and Haddon-Cave repeated his proposal in his 1976 Budget Speech. After observing that the previous two Inland Revenue Ordinance Review Committees had considered only 'technical and administrative' matters and not the 'basic structure' of the Ordinance,[89] he continued:

> By contrast, the intention is that the Third Review Committee will examine the basic structure of the Ordinance. By 'basic structure' I mean such matters as the existence of separate schedular taxes, the territorial ambit of the charge and the lack of progression in the rates. The committee will also be asked to consider the treatment of dividends and, in particular, the proposals formulated in 1975 for a dividend withholding tax and associated measures.[90]

[85] See above at note 20.
[86] See above at note 39.
[87] 1975 Budget Speech, paragraph 89, *Hong Kong Hansard*, 26 February 1975, 493. The reason for this is that a surcharge, if it is to be at all equitable, must be based on taxpayers' total incomes. It was in order to make such a surcharge (namely 'super-tax', later renamed 'surtax') feasible in the United Kingdom that the concept of 'total income' was incorporated in the taxing legislation in 1910. See Sabine (note 30, 1966).
[88] 1975 Budget Speech, paragraph 189, *Hong Kong Hansard*, 26 February 1975, 524. The 'recent' changes to which he referred were some relatively insignificant amendments effected by the Inland Revenue (Amendment) Ordinance 1975. The most important of the 'anticipated' changes were those providing for the withholding tax on dividends - which, of course, never became law.
[89] 1976 Budget Speech, paragraph 216, *Hong Kong Hansard*, 25 February 1976, 568.
[90] 1976 Budget Speech, paragraph 216, *Hong Kong Hansard*, 25 February 1976, 568.

Such a radical review of Hong Kong's system of income taxation was required, he said, for the following reasons:

> [T]he underlying principles on which the present Ordinance is structured were formulated in war-time haste 35 years ago and it is time we considered whether or not they still meet the needs of modern Hong Kong. Quite apart from the fact that there are certain inherent inequities in the present system I am doubtful whether, at given tax rates, it is as productive of revenue as it could be.[91]

He confirmed also that one of his principal concerns was the lack of progressivity in the system, and the inability of the schedular structure to support higher rates of tax on higher incomes:

> I … remain concerned about the proportionality of our earnings and profits tax system at upper levels of income, but a relative shift - and I stress relative shift - of the tax burden must await reform of the system. I have given further consideration this year to some form of surcharge on high level salaries, profits and property incomes but, as I said last year, the absence of a charge on total income and the existence of a system of separate charges on different types of income, coupled with the option to claim personal assessment, makes the imposition of such a surcharge far too difficult and unsatisfactory technically.[92]

The Committee was eventually appointed in late February 1976, but it did not commence work until 15 June.[93] No explanation for this delay seems to have been offered, but again it seems likely that the reason was to allow for further discussions between the government and the representatives of business as to the scope of the Committee's inquiry. It is also possible that the delay was due to the fact that its chairman – J Arthur Johnstone – was a Briton and had to relocate to the colony for the purpose. Johnstone had served as a Commissioner of Inland Revenue in the United Kingdom from 1964 to 1973 and as the secretary of the 1952 to 1955 Royal Commission on Taxation of Profits.[94] Thus, unlike his predecessors, Haddon-Cave did not chair the Committee himself. Nor did he serve as a member of it. Instead, it was decided that it should be chaired by a suitably qualified outside expert. I have been unable to discover, however, whether this decision was taken by the Hong Kong government on its own initiative, or imposed on it by the British government. It is possible that the colonial government thought the Committee's recommendations would be easier to effect if it were chaired by an outside expert (for it is sometimes easier to implement

[91] 1976 Budget Speech, paragraph 216, *Hong Kong Hansard*, 25 February 1976, 568.
[92] 1976 Budget Speech, paragraph 179, *Hong Kong Hansard*, 25 February 1976, 554–555.
[93] Sir Philip Haddon-Cave, 1977 Budget Speech, Annex 9, *Hong Kong Hansard*, 2 March 1977, 660.
[94] *Who Was Who, Volume viii 1981–1990*, A & C Black and St Martins Press, New York, 1991.

someone else's recommendations than one's own). But it is possible also that Johnstone was sent out by London to bring the recalcitrant colony into line.

The Committee's other members were Arthur Duffy (an Australian who had been Hong Kong's Commissioner of Inland Revenue from 1963 until 1972, and who served as the Committee's secretary),[95] Dr Y C Jao (of Hong Kong University's Department of Economics)[96] and three representatives of colonial business interests, namely Q W (later Sir Quo Wei) Lee (a prominent banker),[97] Susan Yuen (of the Federation of Hong Kong Industries and the Hong Kong Management Association) and K A Miller (an accountant turned businessman).[98]

The government's intention, according to the Financial Secretary, was for the Committee to review the 'basic structure' of Hong Kong's tax system;[99] and, as he had said, this would obviously entail an examination of the schedular system of four separate taxes on four different categories of income.[100] Indeed, it is clear from Haddon-Cave's budget speeches of 1975 and 1976 that Maclehose's primary reason (ostensibly, at least) for establishing the Committee was so that it could advise on precisely this issue; and, of course, the advice he wanted was that the schedular structure should be scrapped, and a normal income tax (that is, a comprehensive tax on income as such) instituted in its place.[101] One might, therefore, have expected the Committee's terms of reference to reflect this intention, but they did not.[102] On the contrary, the elaborate wording of the Committee's terms

[95] In Hong Kong, the Commissioner of Inland Revenue is the civil servant who heads the Inland Revenue Department.

[96] As soon as the Committee was established, Jao went on record as supporting a tax on dividends: 'Logical Case' for Dividends Tax: Dr Jao', *The Star*, 27 February 1976.

[97] Lee was the Chairman and General Manager of the Hang Seng Bank (one of Hong Kong's largest and most prestigious financial institutions and now a member of the HSBC group: see Gillian Chambers, *Hang Seng: The Evergrowing Bank*, Hang Seng Bank, Hong Kong, 1991); a member of the Legislative and Executive Councils; and Chairman of the Council of the Chinese University of Hong Kong.

[98] The fact that the representatives of business exactly matched in number those of government and academia (combined) perhaps goes some way to explaining the oblique nature of the Committee's more important recommendations. See below.

[99] 1976 Budget Speech, paragraph 216, *Hong Kong Hansard*, 25 February 1976, 568.

[100] 1976 Budget Speech, paragraph 216, *Hong Kong Hansard*, 25 February 1976, 568.

[101] 1975 Budget Speech, paragraphs 89 and 188, *Hong Kong Hansard*, 26 February 1975, 493, 524; 1976 Budget Speech, paragraphs 179 and 216–217, *Hong Kong Hansard*, 25 February 1976, 554–555, 568–569.

[102] The terms of reference were published in the Committee's report: *Report of the Third Inland Revenue Ordinance Review Committee* (note 5), paragraph 1. They were also published as Annex 8 to Haddon-Cave's 1977 Budget Speech: *Hong Kong Hansard*, 2 March 1977, 653. They were as follows: '*Having regard to the economic circumstances of Hong Kong which dictate* (a) a comparatively low level of taxation; (b) that the system at given tax rates should be as productive of revenue as possible; and (c) that the relevant legislation should be simple and inexpensive to administer; *To consider the present system of taxation of profits and other forms of income contained in the Inland Revenue Ordinance*, and in particular – (a) the system of voluntary personal aggregation under Personal Assessment; (b) the taxation

of reference seems to be slanted towards the preservation of the status quo. This, in turn, suggests that the representatives of business might have privately persuaded the Governor to narrow the scope of the Committee's inquiry.

The terms of reference did not require the Committee to advise on what sort of income tax would be best for Hong Kong. Instead, they required it '[t]o consider the present system of taxation of profits and other forms of income contained in the Inland Revenue Ordinance.'[103] This general mandate was followed by a list of nine more particular matters to which the Committee's attention was specifically directed. Given Haddon-Cave's objectives, one might have expected these to include some reference to the schedular structure of the existing system, or to the possibility of establishing a tax on income as such in its place, but they did not. The list of nine items upon which the Committee was specifically required to pronounce did, however, include 'the system of voluntary aggregation under personal assessment'.[104] This was, indeed, the first item on it. Aggregation is possible only where there are discrete items to be aggregated; the reference to aggregation was, therefore, an oblique reference to the schedular structure. But to refer to what was supposed to be the Committee's basic function in so indirect a manner is, to say the least, peculiar.

Similarly, one might have expected the exemption of offshore income from tax (or, conversely, the possibility of taxing the colony's residents on their offshore incomes) to have featured prominently in the Committee's terms of reference. What the Committee was actually required to consider, however, was 'the territorial ambit of the various charges (having regard, *inter alia*, to the effects of changing commercial practices and recent case law)'.[105] This suggests that the Committee was expected not to assess the merits of the basic policy of exempting offshore income from tax, but merely to advise as to how the erosion of the tax base resulting from 'changing commercial practices and recent case law' could be countered.

Johnstone and Duffy worked on the project full-time for six months; the Committee's other members contributed part-time while pursuing their other full-time occupations.[106] Thus the actual writing of the Committee's

of husbands and wives; (c) the treatment of dividends and its relation to the taxation of corporate profits; (d) the treatment of interest and the relief for interest paid; (e) the territorial ambit of the various charges (having regard, inter alia, to the effects of changing commercial practices and recent case law); (f) the taxation of benefits in kind; (g) the notional basis of the property tax charge; (h) the taxation of specific classes of taxpayer, including profits from shipping; (i) the adequacy of existing relief for expenses incurred by businesses and employees; and then *To make recommendations to the Governor on or before 15th* December 1976.' (Emphasis in original.)

[103] See note 102.
[104] See note 102.
[105] See note 102.
[106] 'UK Expert Heads Special Team to Probe Our Tax laws', *SCMP*, date uncertain, but probably 28 February 1976.

Report, and the research upon which it was based, was presumably undertaken by Johnstone and Duffy. Unlike its predecessors, the Third Review Committee solicited written submissions from the public.[107] It received a good response from the representatives of business (for example, the Hong Kong and Shanghai Bank) and various other representatives of the colony's elite (for example, the Royal Hong Kong Golf Club).[108] '[N]early all' the submissions it received were to the effect that taxes should be reduced.[109] The Committee was also subjected to a barrage of suggestions through the colony's newspapers. These too generally called for reductions in taxation.[110] The government's response was to hint at the inevitability of tax increases in the near future.[111]

THE COMMITTEE'S REPORT

The Committee submitted its Report to the Governor (Maclehose) on 13 December 1976. But the whole exercise ended in almost complete victory for those opposed to taxation and, therefore, opposed to reform.

The Committee exhibited a firm commitment to the business perspective. It assumed for example that taxation functions as 'a restraint on enterprise'[112] and 'involves an interference by authority of the state in the interplay of the economic forces which have a part in the creation of wealth'.[113]

[107] *Report of the Third Inland Revenue Ordinance Review Committee*, paragraph 6.
[108] *Ibid*, appendix A.
[109] *Ibid*, paragraph 8.
[110] For example, 'Hong Kong's Taxation System Under Fire', *Hong Kong Standard*, 8 August 1976; 'Pao Hints at Tax Change Consequences', *SCMP*, 28 September 1976. The Chinese Manufacturers' Association was particularly vociferous: 'Tax Review: CMA Calls For Higher Allowances', *Hong Kong Standard*, 4 August 1976; 'CMA Chief warns Against Frequent Tax Revisions', *The Star*, 13 November 1976; 'CMA Chief Slams Govt Tax Proposal', *Hong Kong Standard*, 20 January 1977. So too were those concerned about the discriminatory tax treatment of married women: Judith Mackay, 'Call for Fair Tax-Deal for Women', *SCMP*, 2 October 1976; Sara Wu, 'Feminist League and Tax Question' *SCMP*, 7 October 1976; Edith Horsfall, 'Separate Taxation for Working Wives' *SCMP*, 21 October 1976; Emily Lau, 'Council Seeks Better Deals for Women', *SCMP*, 26 November 1976; Judith Mackay, 'Campaign against Joint Taxation', *SCMP*, 2 December 1976.
[111] 'Sir Denys' Tax Hike Hint Draws Mixed Reception', *The Gist*, 15 November 1976; 'More Hints of Tax Rise', *SCMP*, 20 November 1976.
[112] *Report of the Third Inland Revenue Ordinance Review Committee*, paragraph 88. It is obviously true that in some circumstances taxation functions as a restraint on enterprise. It is also true, however, that without taxation there would be no state, no rule of law, no recognition of property, no enforcement of contracts, no money and, consequently, no realistic possibility of any but the most rudimentary enterprise. But the Committee did not mention this half of the equation, let alone the possibilities (1) that enterprise might depend upon a reasonably contented workforce or (2) that enterprise, and the fruits of enterprise, might in some sense be communal.
[113] *Report of the Third Inland Revenue Ordinance Review Committee*, paragraph 74. This proposition is true also, but again it is far from the whole truth. For where there is no taxation, there is no state; and where there is no state, the 'interplay' of 'economic forces' invariably produces very little wealth.

Moreover, for reasons it did not explain, the Committee took a peculiarly narrow approach to its task. It ignored altogether a number of basic issues which one might have expected any general review of the system to have addressed. Most importantly, the Committee did not discuss the obvious possibility of following most of the rest of the world and basing the system of income tax on the concept of income. Nor did it consider taxing the offshore incomes of persons resident within the jurisdiction – despite the fact that, again, this was (and is) the usual practice in most of the rest of the world. Given the obviousness of these possibilities, it can only be concluded that the Committee's silence was deliberate.

The thinking behind this deliberate silence, however, remains unclear.[114] Perhaps the businesspeople on the Committee (Lee, Yuen and Miller) were opposed to the establishment of a tax on income as such; and to the extension of the system to cover offshore income; and so thought there was nothing to be gained by raising such undesirable possibilities. And perhaps the Committee's other members (Johnstone, Duffy and Jao) thought that there was no realistic possibility of establishing a tax on income as such; or of taxing offshore income; and that to have mentioned these merely hypothetical possibilities would have been futile, or even counterproductive. As will be seen, this interpretation finds support in the fact that, on both counts, the Committee's peculiar approach reflected the peculiar wording of its terms of reference.

Although mentioning neither the possibility of taxing income as such nor the possibility of taxing offshore income, the Third Review Committee did address the system's structure in a way its predecessors had not. Its most important recommendation was that 'assessments on aggregate income should be mandatory.'[115] That is, rents, salaries,[116] profits and interest, instead of being taxed separately, should be added together, and tax charged on the total.[117] Thus, there would be, in effect, a single tax on income as such – in other words, a 'normal' income tax. It had been principally to produce a recommendation to this effect that the government had established the Committee; and the Committee had duly produced the recommendation the government wanted. The Committee recommended also that the territorial scope of the charge to profits tax should be extended, as the Financial Secretary had proposed in 1973 and 1974, so as to reach the whole profits of firms carrying on business in Hong Kong, except to the extent attributable to branches elsewhere.[118]

In addition to these two fundamentally important proposals, the report made several dozen others, including that married women should continue

[114] The Committee's minutes might reveal its members' thinking; but they have not yet been made accessible to the public.
[115] *Report of the Third Inland Revenue Ordinance Review Committee*, page 27.
[116] And other income chargeable to salaries tax, such as directors' fees.
[117] *Report of the Third Inland Revenue Ordinance Review Committee*, chapter 2.
[118] *Ibid*, paragraph 126.

to be taxed jointly with their husbands (and not given the right to be taxed as individuals), but that a 'wife's earnings allowance' should be introduced;[119] that the taxation of benefits in kind should be extended;[120] that the circumstances in which interest was taxable should be broadened;[121] and that landlords should be taxed on their actual rental incomes, rather than on some lesser notional amount.[122] In fact, the Committee made all the recommendations Haddon-Cave wanted it to make, bar one – the exception being the Financial Secretary's proposed withholding tax on dividends, which the Committee recommended should be abandoned.[123] (As a sop to the Financial Secretary, however, the Committee recommended that the increased rate of profits tax for corporations be retained permanently.)[124]

The Report was published on 16 February 1976. As one would expect, it attracted considerable press coverage. Very little of this, though, was directed to the Committee's most important recommendation (that assessments on aggregate income should be mandatory). Also, to the extent that mandatory aggregation was discussed at all, it was treated as an unimportant technical issue;[125] the basic point of mandatory aggregation (that it

[119] *Ibid*, chapter 3.
[120] *Ibid*, chapter 7.
[121] *Report of the Third Inland Revenue Ordinance Review Committee*, chapter 5. The Committee recommended, most importantly, that 'interest tax should extend to interest paid by a person carrying on a trade or business in Hong Kong on borrowed money employed or expended to produce assessable profits': page 64. Such interest was commonly not taxable because (1) the charge to interest tax was confined to interest derived from Hong Kong (Inland Revenue Ordinance 1947, section 28, as amended); (2) it was maintained by taxpayers and apparently accepted by the Inland Revenue Department that as a matter of law interest is derived from the place where the creditor makes the credit available to the debtor; and (3) the Department accepted also therefore that interest paid by a Hong Kong firm in respect of loan funds made available to it outside Hong Kong was not taxable. Given that such interest was almost invariably deductible, even though not taxable, the scope for avoidance was enormous. It is worth noting that the Department accepted this interpretation of the law (that interest paid by a Hong Kong firm on a loan made available to it outside Hong Kong was derived from outside Hong Kong and therefore not taxable) without litigating the point. See Peter Willoughby, 'Profits Tax: Territorial Source of Profits from Interest' (1978) 8 Hong Kong Law Journal 215; Peter Willoughby, 'Interest Tax and Profits Tax on Interest' (1979) 9 Hong Kong Law Journal 149; and Michael Littlewood, 'The *Orion Caribbean* Case and the Source of Interest' (1999) 7 Asia Pacific Law Review 121.
[122] *Report of the Third Inland Revenue Ordinance Review Committee*, chapter 8. See note 22 above.
[123] *Ibid*, chapter 4. The Committee's objections to Haddon-Cave's proposal were, essentially, first, that the legislation effecting it would have to be complex and, secondly, that much the same revenue could be raised by the very much simpler expedient of raising the rate of profits tax on companies. There was (and is) considerable weight in these points. However, Haddon-Cave's tax would not have exempted dividends paid out of non-taxable profits (that is, mainly capital gains and offshore profits), and the Committee rather obtusely avoided dealing with this point.
[124] *Report of the Third Inland Revenue Ordinance Review Committee*, chapter 4.
[125] See for example 'Taxes: A Few Sighs of Relief', *SCMP*, 22 February 1977 and Philip Bowring, 'Hong Kong: Widening the Net', *Far Eastern Economic Review*, 15 April 1977. Bowring's 4 page analysis included a brief discussion of mandatory aggregation, but without explaining its principal objective (that it would make it easier for the government to increase

would make feasible substantial increases in the rates of tax on large incomes) appears to have received almost no mention whatever in the colony's English-language press.[126] Instead, the newspapers devoted their attentions to a range of secondary issues, such as the taxation of married women, offshore profits, interest, rental income, and ship-owners;[127] and the level of the allowances.[128]

That the debate was conducted in so elliptical a fashion is perhaps revealing of the nature of the political process in the colony. For perhaps the reason the representatives of business did not mention the fact that mandatory aggregation would have made it easier for the government to increase the rates of tax was that they thought that some of the colony's residents might have *supported* the idea of higher taxes on large incomes; and that they might also therefore have supported mandatory aggregation. Equally, that the government did *not* appeal for public support for mandatory aggregation and higher taxes on the affluent tends to confirm that its overriding priority was social stability. Maclehose and Haddon-Cave might have wanted a 'normal' income tax and higher rates of tax on large incomes; but if this was achievable only by alienating the business community and

the rates of tax on large incomes). He also predicted that this recommendation was 'likely to be adopted in the near future'. More presciently, he reported that most of those who had read the Report had 'concluded that the exercise was close to being a waste of time.' Another prominent commentator, Dr Denny Huang, complained that 'a comprehensive single tax' would be 'unfair', but he did not explain why: 'Single Tax Plan Slated', *Hong Kong Star*, 17 February 1977. (Other defenders of the scheduler system seem generally to accept that it is unfair; but maintain that the unfairness is a price worth paying for its other advantages.) P C Woo, a prominent solicitor and onetime member of the Executive Council, was reported as being mainly concerned about the allowances and the taxation of rental income: 'Woo: Give Working Wife Allowance', *SCMP*, 26 March 1977. But the report concluded: 'Mr Woo said he would object strongly to [mandatory aggregation] because this was 'unnecessary in Hong Kong and would lead to abuse and corruption." Like Huang, however, Woo did not explain his criticism (or at least, if he did, his explanation was not reported).

[126] One exception was Philip Bowring, 'Taxation: Hong Kong Looks for More', *Far Eastern Economic Review*, 28 April 1976.

[127] Hong Kong's ship-owners were able to escape tax almost entirely by operating through offshore companies. According to the *SCMP* ('Waiting for Ships that Never Come In', 25 February 1977), 'Hongkong shipowners own a quarter to a third of the world's tonnage registered under flags of convenience.' Two years earlier, the *Economist* had reported ('Hong Kong: The Reluctant Tax Haven', 19 July 1975) that if the Hong Kong government had taxed the profits of a single shipping firm - the Eastern Navigation Co, controlled by Y K Pao (see generally Robin Hutcheon, *First Sea Lord: The Life and Work of Sir Y K Pao*, Chinese University Press, Hong Kong, 1990, forward by Margaret Thatcher) – the revenue raised would have been enough 'to increase its spending on education by 10 per cent.' The *Economist* also predicted that 'Corporate and personal taxation rates may well have to be pushed up to around 20 per cent.' This has yet to happen.

[128] For example, 'Report Backs Tax on Shipping Earnings', *SCMP*, 17 February 1977; 'Tax Review Body Plugs Loopholes: Shock for Businessmen if Govt Accepts Report', *Hong Kong Standard*, 17 February 1977; 'Call for Bigger Personal Allowance' *Hong Kong Standard*, 22 February 1977; 'Interest Tax Proposal 'Bad', *SCMP*, 22 February 1977; 'More Personal Tax Allowance Urged', *SCMP*, 23 February 1977; 'Taxing Problems for Working Wives', *SCMP*, 23 February 1977; and "Outside Incomes' not for Taxing', *SCMP*, 24 February 1977.

drawing attention to the divergence of class interests, then the price was too high.

In any event, Maclehose referred the Report to the Commissioner of Inland Revenue (R V Giddy) to consider its 'technical aspects'.[129] Haddon-Cave then chaired a 'small internal working party' to consider the Report's 'financial, economic, social and political implications … with a view to formulating policy recommendations for the further consideration of [the Legislative] Council.'[130] The working party duly reported back to the Governor, generally endorsing the Committee's Report. Nonetheless, the colonial government ultimately rejected all bar one of the Committee's major recommendations. The exception, again, predictably, was the Committee's suggestion that the proposal to tax dividends be abandoned. This recommendation the government accepted immediately, and no more has since been heard in Hong Kong of taxes on dividends. (The government did, however, adopt the Committee's recommendation that the increased rate of profits tax for corporations be retained permanently. The unofficials were persuaded to accept this, and the 'corporate surcharge', as it has come to be called, remains in effect today.)[131] But the Committee's other major recommendations came to nothing: most importantly, the schedular structure survived, as it does still; and the geographical scope of profits tax remained as narrow as ever, as it, too, does still.[132]

THE COMMITTEE ON THE SCHEDULAR STRUCTURE

The Third Review Committee's most important recommendation was that 'composite return forms should be brought into use'[133] and that 'assessments on aggregate income should be mandatory.'[134] In other words, each taxpayer would be required to file a single return. This would disclose all of his income which (but for the Committee's recommendation) would have

[129] Sir Philip Haddon-Cave, 1977 Budget Speech, Annex 9, *Hong Kong Hansard*, 2 March 1977, 660.
[130] *Ibid*.
[131] See now Inland Revenue Ordinance 1947 section 14 (as amended) and Schedule 8 (as amended). It is called the 'corporate surcharge' because it applies only to corporations, and not to unincorporated firms. In other words, the assessable profits of corporations were taxed at 16.5%, but the assessable profits of unincorporated firms were taxed at the standard rate of 15%, as before. Since 1975, the corporate surcharge has varied from time to time. Sometimes it has been 1%, sometimes 1.5% and sometimes 2%. See Inland Revenue Ordinance 1947 section 14 (as amended from time to time) and Schedule 8 (as amended from time to time).
[132] That is, the wording of the basic charging provision remains unchanged: profits tax is chargeable only on profits 'arising in or derived from' Hong Kong: Inland Revenue Ordinance 1947 section 14 (as amended). Although the wording of the legislation remains unchanged, however, the courts have reinterpreted it so as dramatically to extend its scope. See Michael Littlewood, 'The Problem with the *Dock* Case' (1999) 29 *Hong Kong Law Journal* 59.
[133] *Report of the Third Inland Revenue Ordinance Review Committee*, page 27.
[134] *Ibid*.

been assessable to property tax, salaries tax, profits tax or interest tax. But no longer would separate taxes be charged on rents, profits, salaries and interest. Instead, income of all four categories would be added together, and a single tax charged on the total.[135]

The effect of the Committee's recommendation would have been much the same as the establishment of a tax on total income as such, excepting offshore income. Indeed, the Committee seems to have thought it would be exactly the same, for, according to the Committee, the four existing taxes did in fact cover, between them, all significant forms of income (other than, of course, offshore income and capital gains).[136] Consequently, there was no possibility that income might escape tax altogether as a result of its not falling within one of the four categories. In other words, there were no gaps in the schedular structure; moreover, said the Committee, if gaps were to appear, it would of course be necessary to fill them.[137]

Thus, the Committee suggested what, according to its own analysis, would have amounted, for practical purposes, to the scrapping of the schedular system of four separate taxes on four separate categories of income and the substitution of a single comprehensive tax on all income originating in Hong Kong (in other words, an income tax which exempted offshore income but was otherwise normal). This, it is clear, is exactly what the Committee intended: the 'end result' of implementing its recommendation, said the Committee, 'would amount to no more than the introduction of a system similar to that operating in most countries.'[138] But the Committee did not recommend the elimination of the fourfold categorisation of assessable income. It did not, that is, recommend that tax should be charged on income as such. Instead, it limited itself to the suggestion that the four categories should be retained; but that a single tax should be charged on the total, rather than on the four categories separately. Why, then, did the Committee not take the final step? Why did it not propose that the schedules be scrapped and that income as such be taxed? Why, indeed, did it not even mention the possibility? Scrapping the schedular taxes would have been simpler; and it would have brought Hong Kong's tax system into closer conformity with those of the rest of the world. The Committee offered no explanation, but several reasons seem possible.[139]

First, it may be that some of the Committee's members (Johnstone, Duffy and Jao?) favoured the establishment of a normal income tax; that others (Lee, Yuen and Miller?) were opposed; and that 'mandatory aggregation' was the compromise agreed upon.

[135] *Ibid*, chapter 2.
[136] Dividends were not taxed as such, but profits (whether distributed as dividends or not) generally were (except for capital gains and offshore profits).
[137] *Report of the Third Inland Revenue Ordinance Review Committee*, chapters 1 and 2.
[138] *Ibid*, paragraph 45.
[139] Again, it might be useful to examine the Committee's minutes.

Secondly, the Committee might have thought that the approach it recommended would provoke less opposition. Scrapping the four categories and taxing income as such would have been tidier, but it would have entailed the use of the term 'income' – which Hong Kong's business community regarded as repellent.[140] Moreover, some might have thought that taxing income as such might have extended the charge to tax. By the Committee's own reckoning, as I have said, there were no gaps in the schedular structure; therefore the Committee's unstated position must have been that to tax income as such would not have extended the charge. Others, however, might not have accepted this; and so might been less opposed to 'mandatory aggregation' than to a tax on income as such. Preserving the familiar schedular structure would have made it quite clear that the Committee's recommendation would not bring to tax any income not already assessable. It was obvious that, as Haddon-Cave put it, mandatory aggregation 'would not in any way extend the totality of the existing charges'.[141]

Thirdly, in 1910, the British government, when moving from a system under which different categories of income were separately taxed to one under which a single tax was charged on total income, had retained the categories (and these redundant categories, or 'schedules', as they are called, still survive today).[142] Thus, apart from its substantive merits, the Committee's recommendation could be presented as following the restructuring of the British tax system seventy-odd years previously.

Fourthly, the approach adopted by the Committee resonates intriguingly with the peculiar drafting of its terms of reference. As I have said, these mentioned neither the existing schedular structure nor the possibility of taxing income as such, except obliquely by reference to 'the system of voluntary aggregation under personal assessment.'[143] The Committee's recommendation was correspondingly oblique: 'mandatory aggregation' really meant gutting the schedular structure of its original function, but without saying so. Not only was the Committee's recommendation oblique but so, too, was its whole analysis: the Report's first substantive chapter dealt with this issue exclusively and at some length, but without discussing the obvious possibility of simply taxing income as such and abolishing the separate categories of assessable income.[144] In other words, the Committee completed its review of the basic structure of Hong Kong's system of income taxation without even mentioning the possibility that

[140] It was for this reason that the Inland Revenue Ordinance was not called the Income Tax Ordinance, as had been originally proposed See CO129/582/7; CO129/586/8; CO129/586/9; CO129/589/12; CO129/589/14; and CO129/595/3.
[141] 1977 Budget Speech, Annex 8, *Hong Kong Hansard*, 2 March 1977, 654.
[142] Income and Corporation Taxes Act 1988.
[143] See note 102 and the corresponding text.
[144] *Report of the Third Inland Revenue Ordinance Review Committee*, chapter 2.

the territory might adopt the approach taken in most other developed jurisdictions.[145]

This omission was striking, but the Committee's explanation of the advantages of mandatory aggregation was otherwise sound. First, the Committee said, the existing system was 'awkward'[146] and resulted in 'considerable waste and duplication.'[147] It required taxpayers to file separate returns in respect of their income chargeable to salaries tax and profits tax and, in the case of property tax, it required separate returns in respect of each rateable unit of property.[148] (There was no requirement to file a return of interest income, since interest tax was deducted at source.) All this was inconvenient in itself because of the multiplicity of records it produced. More importantly, it meant that separate recovery actions were necessary in cases of default. Further, the schedular system, combined with the option of personal assessment, meant that the Department was obliged to make a large number of refunds.[149] Finally, the non-existence of 'personal' files made investigation difficult.[150]

The Committee's second reason for recommending that 'assessments on aggregate income should be mandatory' was its concern about the 'horizontal anomalies' which, as it observed, were 'inherent' in the schedular system.[151] As the Committee said, these would be eliminated by its proposal.

Finally, the Committee came to the crux of the matter: the aggregation of income from different sources was, it said, 'an essential step towards the introduction of a further degree of progressivity, should this be thought necessary.'[152] It was principally for this reason that the British and

[145] Even Britain's anachronistic schedular system has always included a residuary provision, bringing to tax income not otherwise specified: see Income Tax Act 1803 Schedule D Case 6.
[146] *Report of the Third Inland Revenue Ordinance Review Committee*, paragraph 37.
[147] *Ibid*, paragraph 36.
[148] *Ibid*, paragraphs 34–38.
[149] *Ibid*, paragraph. In various circumstances, personal assessment would produce a lesser liability than the schedular taxes; but the schedular taxes would have been collected first, thus necessitating a refund.
[150] *Ibid*, paragraph 38. By 'personal' file, the Committee meant a file giving a composite picture of an individual's liability to each of the taxes provided for by the Inland Revenue Ordinance. Exactly why 'personal' files did not exist is not clear, however. There was nothing in the Inland Revenue Ordinance prohibiting the Department from collating a taxpayer's multiple returns and thus creating a 'personal' file, if it wanted to. In this respect Hong Kong's legislation was markedly different from the nineteenth-century British model upon which it was otherwise largely based, in that that system went to Byzantine lengths to prevent the government and its officers from compiling personal files and so discovering any taxpayer's total income: see Income Tax Act 1803. Perhaps, then, Hong Kong's Inland Revenue Department felt some ethical or political restraint in this regard, in the absence of specific empowering legislation; or perhaps it simply lacked the resources. Nowadays, it seems that the Department does maintain personal files, but exactly when it began to do so, and why it felt free to change its practice in this regard, is unclear.
[151] *Report of the Third Inland Revenue Ordinance Review Committee*, paragraphs 39–40. See note 28.
[152] *Ibid*, paragraph 46.

Hong Kong governments regarded the establishment of a normal income tax in the colony as necessary; and it was presumably for the same reason also that the Committee's recommendation was opposed by the representatives of business; and that in the end it was never implemented. But this is not apparent from the public record, for neither the official nor the unofficial members of the Legislative Council seem to have made any further public mention of the advantages, or disadvantages, of progressivity. The colony's press, too, paid little attention to this aspect of the issue.[153]

The Committee reported in 1976. In 1977 the Report was considered by the Commissioner of Inland Revenue and the government's own internal working party.[154] It was not until Haddon-Cave's 1978 Budget Speech, therefore, that any indication was given as to which, if any, of the Committee's recommendations the government intended to implement. The Financial Secretary then reported to the Legislative Council that some of the Committee's recommendations had been accepted (notably, to forget about tax on dividends) and others rejected (notably, to 'restore' profits tax to its original territorial ambit), but that mandatory aggregation was 'still under examination'.[155] Eventually, in 1979, Haddon-Cave's Budget Speech contained a statement revealing the government's decision on this crucial issue. This was the most important statement of tax policy issued by the Hong Kong government since the establishment of a peacetime system of income tax in 1947, but it was not given the prominence its importance might have been thought to warrant, for Haddon-Cave excluded it from his Budget Speech proper altogether and, instead, shamefacedly tucked it away in the fine print appended to the printed version of the speech.[156] The government had decided, explained the statement, that 'consideration of compulsory aggregate assessment should be deferred for the time being.' This was pathetic, but the reason offered for maintaining the schedular status quo was more so: it was, the statement continued, that the Inland Revenue Department was 'in the throes of a major computerisation programme' and the government therefore did not wish to place 'further strain' on the Department 'at this time'.[157]

Since then the matter has remained in abeyance. More than twenty years later, nothing has been done: the government has neither implemented the Committee's proposal, nor given any reason for not doing so. Thus the official

[153] It appears, indeed, that the Hong Kong people were generally unaware that mandatory aggregation was (or, at least, was thought by the government to be) a prerequisite to substantial increases in the rates of tax. For example, Dr Denny Huang, who was one of the very few in Hong Kong to advocate increased taxes on the affluent (Denny Huang, 'Rich Get Rich But ....', *The Star*, 1 December 1976), *opposed* mandatory aggregation: 'Single Tax Plan Slated: Raise Allowance Ceiling, Says Huang', *The Star*, 17 February 1977.
[154] See above at note 129.
[155] 1978 Budget Speech, paragraph 179, *Hong Kong Hansard*, 1 March 1978, 546.
[156] 1979 Budget Speech, Annex 15, *Hong Kong Hansard*, 28 February 1979, 600.
[157] 1979 Budget Speech, Annex 15, *Hong Kong Hansard*, 28 February 1979, 600.

position seems to be that the peculiar and 'inherently inequitable' structure of Hong Kong's tax system has been preserved for no other reason than that in the late 1970s the Inland Revenue Department acquired a new computer. This is obviously absurd: the truth must be that the unofficial members of the Legislative Council privately indicated to the government that they would not support this reform; and that the government adhered to the convention of not using the official majority to impose its will on the unofficials.[158]

THE COMMITTEE ON THE EXEMPTION FROM TAX OF OFFSHORE INCOME

One might have expected a review of the 'basic structure'[159] of Hong Kong's tax system to have examined the possibility of withdrawing the exemption from tax of offshore income. But this the Committee chose not to do. In other words, the Report did not discuss the possibility that it might have been in Hong Kong's interest to adopt the approach taken in most of the rest of the developed world. (Since it similarly ignored the possibility of introducing the basic concept of 'income', this meant that the Committee completed its review of the basic structure of Hong Kong's system of income taxation without evaluating the two basic differences which set it apart from most other tax systems in the developed world.)[160]

This was the Committee's most striking omission. (Although the Committee also ignored the possibility of basing the system on the concept of income, it did at least recommend 'mandatory aggregation', which would have had much the same effect.) This is not to say that the exemption of offshore income from tax should have been abandoned, or even compromised (though in most countries it is generally regarded as obvious that offshore income should be taxed).[161] But that the possibility was not

[158] Again, I have found no direct evidence of this; but, again, this is not surprising. See note 69.

[159] Sir Philip Haddon-Cave, 1976 Budget Speech, paragraph 216, *Hong Kong Hansard*, 25 February 1976, 568.

[160] Some jurisdictions exempt offshore income from tax if it is attributable to an offshore permanent establishment, or if it is taxed in the jurisdiction from which it is derived; Hong Kong exempts offshore income from tax even if the taxpayer has no offshore establishment; and whether or not it is taxed elsewhere.

[161] There are good reasons why Hong Kong residents should not be taxed on their offshore incomes. In particular, (1) exempting offshore income from tax is an easy (if unnecessarily generous) way of providing relief from double taxation; (2) it is widely maintained (although on the basis of scant evidence) that if Hong Kong were to tax offshore profits it would harm the territory's economy; and (3) there appears never to have been significant popular support in Hong Kong for the idea of taxing offshore income. Even so, one might have expected the Committee to have appraised these factors, not to have taken them as so self-evidently conclusive that they did not even need to be mentioned. That it did not do so cannot be attributed to any constraint imposed by its terms of reference, for it regarded these (see note 102) as permitting it to discuss 'all the points we wished to raise': *Report of the Third Inland Revenue Ordinance Review Committee*, paragraph 21.

even discussed is a measure of the elliptical nature of the debate, and of the peculiarity of the policy-making process in colonial Hong Kong.

Although the Committee did not examine the basic policy of exempting offshore income from tax, it did address the scope of the exemption; and it recommended that 'profits tax should extend to profits which a business actively carried on in Hong Kong obtains without the substantial intervention of any branch elsewhere.'[162] This (like the Committee's analysis of 'mandatory aggregation') was curiously consistent with the peculiar drafting of its terms of reference, which, as I have mentioned, did not specifically require it to assess the merits of the source principle but, instead, directed it to consider 'the territorial ambit of the various charges (having regard, inter alia, to the effects of changing commercial practices and recent case law)'.[163] The recommendation was also substantially identical to the proposals made by Haddon-Cave in 1973 and 1974. In effect, the Committee had independently endorsed both Haddon-Cave's diagnosis of the problem and his proposed solution.

One might, therefore, have expected the government to proceed to implement the Committee's recommendation, but it did not. Although Haddon-Cave announced, in his 1978 Budget Speech, that the government had rejected the recommendation,[164] its justification for this decision was hidden away in the fine print appended to the printed version of the speech (just as its justification for not adopting 'mandatory aggregation' was to be hidden away the following year).[165] And (as in the case of mandatory aggregation) the government's justification for not adopting the Committee's recommendation on source was pathetic: it was that the government found the recommendation 'uncertain in purpose and limited in effect' and thought that it would 'give rise to practical difficulties in administration.'[166] Given that this clearly amounted to a reversal of the policy declared by the Financial Secretary in 1973 and 1974, one might, perhaps, have expected further elaboration, but none was forthcoming.

SINCERE FAILURE OR SUCCESSFUL CHARADE?

Haddon-Cave's attempts at reform in the 1970s progressed much further, and much more publicly, than those of his predecessors, and so represented clearer reversals of government policy when they failed.[167] But the unofficial

[162] *Report of the Third Inland Revenue Ordinance Review Committee*, page 79; see also paragraph 126.
[163] See note 102.
[164] 1978 Budget Speech, paragraph 178, *Hong Kong Hansard*, 1 March 1978, 546.
[165] See above at note 156.
[166] Sir Philip Haddon-Cave, 1978 Budget Speech, Annex 15, *Hong Kong Hansard*, 1 March 1978, 584.
[167] The First and Second Review Committees, as I have said, were authorised to consider only relatively minor matters and not the basic structure of the tax system.

members of the Legislative Council had an unblemished record of firm and vociferous opposition to tax reform. It must, therefore, have been obvious to Haddon-Cave and Maclehose that they would oppose the reforms proposed in the 1970s.[168] Why, then, did the government launch itself so publicly on a campaign to reform the tax system in the first place, if it had neither the support of the business community nor the will to proceed without it?

First, it is possible that the government hoped to persuade most of the unofficials to support its proposals for reform but, in the event, failed to do so. In other words, it is possible that the government, although anticipating some opposition, misgauged its strength. By the 1970s, Hong Kong's peculiar tax system must have seemed an even more embarrassing anachronism than before. Also, the methods used to avoid taxes were becoming increasingly sophisticated. Consequently, it is likely that the revenue lost because of the Inland Revenue Ordinance's flaws was increasing not only in absolute terms but also as a percentage of the total.[169] These factors may have led the government, first, to decide that reform was even more necessary than before and, secondly, to hope that the business community would agree.

If the government misjudged the business community's opposition to tax reform, it is possible (in the 1970s, as in previous periods)[170] that one reason for this was its failure to appreciate the vehemence of Chinese feeling on the subject. Moreover, by the 1970s Hong Kong's Chinese businessmen had become much more powerful than previously. They had gained control of a much larger share of the colony's economy and of the unofficial seats in the Legislative Council[171] – and they remained, as they had always been, generally more opposed than the expatriates to reforms of the kind proposed by the government. Furthermore, Hong Kong's remarkable economic success was widely attributed (by both Chinese and expatriates) to the lightness of its taxes; equally, Britain's relative economic decline was widely attributed to the heavy spending of successive British governments and the heavy taxes by which it had been financed. Consequently, there was an

[168] On 12 August 1975 (after the Committee had commenced work but before it had reported), Haddon-Cave delivered a speech to the Hong Kong Rotary Club (published in the *SCMP*, 13 August 1975), in which he recounted that the establishment of a system of provisional tax had taken nine years (from 1966 to 1975) and continued: 'Bearing in mind that this recommendation was really of only a technical nature, I shudder to think of the time consuming controversy which is likely to greet any radical recommendations that the [Third Review Committee] may like to make about the basic structure of the ordinance.'

[169] On the other hand, by the 1970s many of the loopholes and other inadequacies from which the Inland Revenue Ordinance 1947 had originally suffered had been remedied. For example, the Ordinance originally left very wide scope for Hong Kong firms to make payments (of, for example, interest) to offshore associates in such a way that they would be deductible by the firm paying them but not taxable to the firm receiving them. By the 1970s, the scope for such abuse had been considerably narrowed, but far from eliminated.

[170] See Littlewood (note 2).

[171] Welsh (note 50), chapter 16.

increasing tendency for the colony's residents to think that they had little to learn from Britain on the subject of taxation and public finance (except how not to go about it); and that, on the contrary, the British government might do well to emulate the colony. Indeed, by the 1970s, commentators from other parts of the world were beginning to hold up Hong Kong as an exemplar of sound economic management.[172]

Secondly, it is possible that the government anticipated that most of the unofficials would oppose its reforms; and that it planned, at the time Haddon-Cave announced the reforms, to use the official majority to out-vote them; but that it subsequently decided not to do so. It is very unlikely that the government ever intended to out-vote the unofficials if they unanimously opposed reform; but it is possible that it intended to use the official votes to determine the issue if it could raise a respectable level of unofficial support for reform. Again, however, this explanation, on its own, is unconvincing. By the 1970s, the colonial administration's very existence was increasingly difficult to justify, let alone its authority to force through unpopular tax measures against the will of legislators who supposedly represented the public interest. Moreover, in 1947, most of the unofficials had at least been British, whereas, by the 1970s, most of them were Chinese. Consequently, to have resorted to the official majority in the 1970s would have meant treating the world to a spectacle which would have appeared not only colonialist but racist.

A further factor, and a crucial one, is that the Hong Kong government, and the Financial Secretary in particular, were acting on instructions (or, at least, heavy-handed suggestions) from London. According to Norman Miners (the author of what is still the best general text on Hong Kong's political system),[173] Maclehose proposed in 1973 to promote Haddon-Cave from Financial Secretary to Chief Secretary,[174] but this was vetoed by the British government (Edward Heath's Conservative administration) on the grounds that Haddon-Cave had 'resisted pressures from London for increased spending.'[175] By putting pressure on the colonial government to increase spending, the Heath government was also, at least implicitly, if not expressly, putting pressure on it to increase taxes and to undertake whatever structural reform of the tax system was necessary to that end (for how otherwise was the increased spending to be paid for?).

In 1974, Harold Wilson's Labour government was returned to power. The new Labour government was naturally no less critical than the

[172] See in particular Alvin Rabushka, *Value for Money: The Hong Kong Budgetary Process*, Hoover Institution Press, Stanford, 1976; and A J Youngson, *Hong Kong Economic Growth and Policy*, Oxford University Press, Hong Kong, 1982.
[173] Miners (note 7).
[174] In Hong Kong's system of government, the Chief Secretary was (and is still) second only to the Governor (now Chief Executive).
[175] Miners (note 7), 216. This was, says Miners, '[p]robably the last time that the Foreign Office was actively involved' in an appointment made by the governor of Hong Kong: *ibid*.

Conservatives of the Hong Kong government's excessive parsimony. Moreover, it is likely that the Labour government, if not its Conservative predecessor, tended to regard a maximum rate of income tax of 15% as manifestly inadequate, irrespective of spending. Miners recounts that James Callaghan, the Foreign Secretary in the new Labour government, was pressed by Labour Members of Parliament 'to instruct the Hong Kong government to introduce a wealth tax in the colony',[176] but refused, saying 'Introduction of any tax in Hong Kong would be a matter for the Hong Kong government.'[177] Callaghan explained:

> I think that there is a good case for increasing taxation in considerable measure in Hong Kong, but that is a matter for them. The fact that I am not able to issue a directive should not lead the honourable gentlemen to assume that there are not many aspects of the taxation system [in Hong Kong] which could be improved.[178]

The confusing triple negative perhaps reflects Callaghan's discomfort at presiding over an undemocratically governed colony whose approach to taxation and public finance would have been wholly unacceptable in Britain (even now, let alone in the 1970s). In any event, Miners' account of the Labour government's interest in Hong Kong's tax system continues:

> While the Labour government of 1974–79 was in power, Lord Goronwy-Roberts was the Minister of State at the Foreign and Commonwealth Office responsible under the Secretary of State [Callaghan] for all matters relating to Hong Kong. During this period he pressed the [Hong Kong] Governor [Maclehose] to introduce a more progressive system of taxation and for further advances in social programmes.[179] Hints of these promptings from London leaked out to the unofficial members and the press, leading to critical comments in the Legislative Council.[180] In reply the Chief Secretary[181] reminded the Council, 'We should not close our ears to suggestions and criticisms from elsewhere. In particular we are obliged by reason of our constitutional status to pay attention to the views of those who are responsible for our affairs in the United Kingdom.'[182] However, though the budgets introduced

[176] *Ibid*, 142.
[177] *House of Commons Debates*, 6 November 1974, cols 1066–8; quoted in Miners (note 7), 142.
[178] *Ibid*.
[179] Miners says: 'I interviewed Lord Goronwy-Roberts in August 1979 after he had left office. He expressed the position as follows: '....I certainly pressed Hong Kong for a more progressive system of taxation, but I could not have imposed it...." Miners (note 7), 143, note 10.
[180] Miners was here presumably referring to James Wu, *Hong Kong Hansard*, 27 October 1976, 89; and Hilton Cheong-Leen, *Hong Kong Hansard*, 27 October 1976, 93.
[181] Sir Denys Roberts, QC (who had been promoted from Attorney General to Chief Secretary after the British government had vetoed Maclehose's proposal to promote Haddon-Cave to that position).
[182] *Hong Kong Hansard*, 11 November 1976, 205–206.

> from 1975 to 1979 did show considerable increased expenditure on social services (continuing the trends of the early 1970s), *there was little sign that the Financial Secretary had taken Lord Goronwy-Roberts's other suggestions to heart.*[183]

This account seems entirely sound, except for the words emphasised. For, contrary to Miners' conclusion, there was every sign, in the form of the quixotic Third Inland Revenue Ordinance Review Committee, that Haddon-Cave had taken Lord Goronwy-Roberts' suggestions very much to heart. For the circumstances suggest that one reason, and perhaps the principal reason, that the Hong Kong government announced proposals for tax reform in the 1970s was simply that this was what London wanted. That is, it seems possible that the colonial government had no real expectation of establishing a normal income tax; and that its real reason for establishing the Third Review Committee was not to achieve its ostensible objectives at all, but merely to placate London. It is possible that Haddon-Cave's attempts to broaden the territorial scope of profits tax (in 1973 and 1974) and to introduce a tax on dividends (in 1975) were similarly motivated. Alternatively, it may be that Maclehose and Haddon-Cave genuinely intended to effect these reforms; and that the opposition they encountered brought home to them the futility of trying to persuade the representatives of business to endorse the establishment of a normal income tax. In any event, although none of the major reforms came to pass, Haddon-Cave was promoted from Financial Secretary to Chief Secretary in 1981.[184] He had not established a normal income tax, but presumably he had satisfied London that he had done all that was feasible.

There remains to consider one last factor. Like his predecessors, Haddon-Cave was constantly concerned about the possibility that the government would run out of money. The growth in government spending under the Maclehose administration was indeed massive.[185] Like his predecessors' medium-term projections of planned expenditure and expected revenues, Haddon-Cave's routinely produced substantial deficits.[186] Consequently, the argument for tax reform rested heavily on financial necessity. But Hong Kong's miraculous economic boom continued,[187] and bore along with it the revenues of the government. There were no major changes in the methods by which the government financed itself, and yet its revenues rose from $3 billion in 1971 to $33 billion in 1981. In particular, the Inland Revenue Ordinance 1947 remained basically unchanged, and yet its yield rose from

[183] Miners (note 7), 142.
[184] In the course of the research upon which this paper is based, I asked Sir Philip Haddon-Cave if I could interview him, but he declined. He died in 1999.
[185] See above at note 55.
[186] For summaries, see Rabushka (note 172) and Youngson (note 172).
[187] See above at note 51.

$929 million in 1971 to $8.9 billion in 1981.[188] Haddon-Cave's budgets generally assumed increased revenues. Indeed, by the standards prevailing almost everywhere else in the world, his assumptions as to revenues would have been rash. But the Hong Kong government's revenues rose even faster than his budgets predicted. Consequently, the deficits he predicted never came to pass. Rather, as in previous years, the government generally operated at a surplus. As a result, despite colossal increases in public spending,[189] the government's reserves grew from $2.5 billion in 1971[190] to $16 billion in 1981 (an amount equal to more than 50 percent of total annual public spending).[191] And so the case for tax reform based on financial necessity disappeared.

SUBSEQUENT DEVELOPMENTS

For the next thirty years, the Hong Kong government expressed very little interest in tax reform. The main reason for this was that it continued, almost always, to operate at a surplus (despite very low rates of tax and very large increases in public spending). Eventually, though, Hong Kong's miraculous economic growth stalled. The cause was the 'Asian financial crisis' which began in the second half of 1997 and which caused the newly-installed SAR government to run repeated substantial deficits. The government's response, in 2000, was to establish a committee 'to consider what types of broad-based taxes (including consumption-related taxes) may be suitable for introduction in Hong Kong'.[192]

The Advisory Committee on New Broad-based Taxes (as it was called) duly reported in February 2002. Like the Third Inland Revenue Ordinance Review Committee, the Advisory Committee appears not to have considered

[188] Sir Philip Haddon-Cave, 1981 Budget Speech, table 13, *Hong Kong Hansard*, 25 February 1981, 568. Although the Inland Revenue Ordinance remained basically unchanged, the number of taxpayers increased from less than 2% of the populace in the 1950s and 1960s to about 8% (of a substantially larger population) in 1976: R V Giddy (Commissioner of Inland Revenue), 'More than Two Per Cent of Population Pay Taxes', *SCMP*, 4 September 1976. The reasons for the increase were (1) that real incomes increased dramatically and (2) that the allowances, although increased from time to time, did not keep pace with inflation. But the relative importance of these two factors remains unclear. It seems likely that the effective expansion of the tax system to persons previously untaxed contributed to the government's difficulties in implementing reform, though this effect was somewhat countered by the (presumably strategic) concession of significant increases in the allowances in 1973 and 1976.
[189] See above at note 55.
[190] Sir Philip Haddon-Cave, 1972 Budget Speech, *Hong Kong Hansard*, 1 March 1972, 421.
[191] Sir John Bremridge (Haddon-Cave's successor as Financial Secretary), 1982 Budget Speech, paragraph 41, note 24, *Hong Kong Hansard*, 24 February 1982, 433. Public spending in 1981/1982 totalled $27 billion: ibid, paragraph 34. The reserves thus amounted to 59% of spending.
[192] Advisory Committee on New Broad-based Taxes, *Final Report to the Financial Secretary*, Hong Kong Government Printer, Hong Kong, 2002, Annex A.

the possibility that Hong Kong might adopt a 'normal' income tax – that is, a tax on income as such. The Committee did consider taxes on offshore income, dividends, interest and capital gains – but it framed its analysis in terms of separate taxes on income of these kinds, rather than as aspects of a comprehensive tax on income as such. In any event, the Committee recommended against the taxation of income of these kinds.[193] It thus appears probable that the supposedly temporary schedular system of taxation devised in 1940 will endure for the foreseeable future.[194]

CONCLUSION

The failure of the British and Hong Kong governments to reform the territory's tax system in the 1970s is important, because it explains why the peculiar and anachronistic tax system established in 1940 remains intact today. The episode is also an instructive example of the working of British colonial governance – at least in Hong Kong and perhaps elsewhere. It illustrates the tension between the British government and a colonial elite; and it shows how, on this occasion, the colonial elite achieved an almost total victory.

Judged by any reputable criteria, Hong Kong's tax system is grossly flawed. In particular, it is 'inherently inequitable' (as the Hong Kong government itself has repeatedly acknowledged, though not recently) and it permits avoidance and evasion of kinds and on a scale that in other developed jurisdictions would be regarded as scandalous. Also, it is so structured as to make it incapable of supporting high or even moderate rates of tax. Depending upon one's point of view, this might be seen either as its most serious deficiency, or as the holy grail of tax design. Despite its flaws, Hong Kong's tax system has proved remarkably successful. In particular, it has generally, together with the government's other sources of revenue, raised more money than the government has wished to spend. More impressive still, the Hong Kong people seem more content than other peoples not only with the burden of exceptionally light taxation (as one might expect) but

[193] According to the Advisory Committee, a tax on offshore income would be 'complex' and its yield 'negligible'. Similarly, a tax on dividends, it said, would be 'complex' and the yield 'would not be significant.' A tax on interest would be easily avoided, and would adversely affect Hong Kong's development as an international banking centre. And a tax on capital gains 'should not be pursued given its limited ability to yield significant revenue'. See *Final Report to the Financial Secretary* (note 192), pages 15–18. But the Advisory Committee offered virtually no further analysis or data in support of these conclusions.

[194] The Advisory Committee's principal recommendation was for the establishment of a general value-added tax on goods and services: *Final Report to the Financial Secretary*, pages 25–26. Whether this will be implemented remains to be seen. If it is, it will be by far the most important change in the territory's tax system (and perhaps the most important change in its system of government) since 1947, when a permanent peacetime system of income tax was established.

also (more intriguingly) with the balance of taxation and public spending. It may be, of course, that the Hong Kong people are less content than they seem; and that the reason they have not voiced their dissatisfaction more loudly is that, in the absence of democracy, they have thought it futile to do so.[195] Even so, the successes of Hong Kong's tax system suggest that there might be something wrong with the criteria by which it has been found wanting; and with the theory which surrounds these criteria.

What, if anything, the rest of the world might be able to learn from Hong Kong's peculiar approach to taxation and public finance is a question which is large, difficult and beyond the scope of this paper.[196] But in order to learn anything from Hong Kong's tax system, it is necessary to understand it. And yet to understand it is difficult, because the literature is very far from complete. This could of course be said of most tax systems, or even all; but the gaps in the literature on Hong Kong's tax system are unusually large and, given the system's remarkable successes, especially unfortunate. This paper, I hope, goes some way to redressing one of these gaps.

[195] In 1991 the United Democrats (one of Hong Kong's major political parties) made the suggestion, radical by Hong Kong standards, that the corporate rate of profits tax should be increased from 16.5% to 17.5%. In retrospect, however, even this modest proposal seems to have been regarded as unappealing to the electorate for, in the next election, in 1995, it was not repeated.

[196] One possibility, already alluded to, is that Hong Kong's tax system is instructive on the subject of fiscal constitutionalism. Another is the 'flat tax' proposals put forward in the United States in recent years, which seem to be largely derived from an analysis of Hong Kong's tax system. One of the leading proponents of the flat tax is Alvin Rabushka. See Robert E Hall and Alvin Rabushka, *The Flat Tax*, 2nd edn, Hoover Institution Press, Stanford, 1995. Rabushka is also the author of a number of important works on Hong Kong's system of government. See in particular Alvin Rabushka, *Value for Money: The Hong Kong Budgetary Process*, Hoover Institution Press, Stanford, 1976; Alvin Rabushka, *Hong Kong: A Study in Economic Freedom*, Hoover Institution Press, Stanford, 1979; and David Newman and Alvin Rabushka, *Hong Kong under Chinese Rule: The First Year*, Hoover Institution Press, Stanford, 1998.