JIA 72 (1946) 0035-0078

INCOME TAX AS AFFECTING LIFE ASSURANCE OFFICES

By A. H. SHREWSBURY, F.I.A.
Secretary and Actuary of the Law Union and Rock Insurance Company, Ltd.

[Submitted to the Institute, 26 March 1943]

'If there be one point free from obscurity in the Act of 1842 it is this, that the Legislature intended all traders, whether in groceries, annuities or other articles of commerce, to be assessed upon the same footing.' Lord Watson in The Gresham Life Assurance Society *v.* Styles.*

1. Scope of this paper

The main object is to discuss principles and therefore many points of detail will be omitted, however intrinsically interesting they may be. Satisfactory consideration of principles entails reference to all classes of business which involve an actuarial valuation (viz. life assurance and annuity business, sinking fund business and permanent sickness insurance business). Reference will be made to the National Defence Contribution and the Excess Profits Tax, which are based upon income-tax legislation. The subject in mind is the relation of such taxation to insurance business and funds of the classes mentioned, as distinct from other aspects of income tax which an insurance office encounters, and it will be considered solely from the point of view of an office established in the United Kingdom which transacts business only in the United Kingdom. In view of the paper by Messrs S. J. Rowland and F. H. Wales on 'The Taxation of the Annuity Fund' (March 1937, *J.I.A.* Vol. LXVIII), only brief reference will be made to annuity business, and it will be assumed that it is unnecessary, in describing taxation processes, to include explanations or qualifying phrases on account of annuity business.†

2. Case I

Events of recent years have greatly increased the practical importance of Case I of Schedule D which regulates the application of income tax to trading profits. The Rules of Cases I and II of that Schedule appertain to the manner in which such profits are to be computed for income-tax purposes. As is well known, the rules are remarkable for what they omit to say, and, from the point of view of an actuary, are not only insufficiently informative but are positively confusing. Throughout income-tax legislation, the phrase 'profits and gains' is used indifferently whether the context is profit or interest: in life assurance business that difficulty is felt acutely. It is therefore of primary importance to inquire how far investment income enters, under Case I, into the computation of profits.

* In relation to the particular point being considered, this passage, as would be expected, formed part of a sound argument.

† The following abbreviations will be used: F.A. = Finance Act; I.T.A. or The 1918 Act = The Income Tax Act 1918; N.D.C. = National Defence Contribution; E.P.T. = Excess Profits Tax; A.C. = Law Reports, Appeal Cases, House of Lords; T.C. = Official Reports of Tax Cases for Commissioners of Inland Revenue; The Royal Commission = The Royal Commission on The Income Tax, 1920.

3. Case I. Interest to be excluded

The practice of omitting taxed investment income from a computation of profits under Case I is supported by judicial decisions and remarks, the most important of which arose in the case of Salisbury House Estate Ltd. *v.* Fry.* In that case Lord Tomlin said: 'The subject matter, namely, land in respect of its property quality being necessarily taxed under Schedule A, cannot be brought again under any other Schedule. To do so would offend the rule against double taxation'; and Lord Atkin said: '...annual income derived from the ownership of lands...can only be assessed under Schedule A...it makes no difference that the income so derived forms part of the annual profits of a trading concern...the Schedules are mutually exclusive...the specific income must be assessed under the specific schedule and...D...is a residual schedule so drawn that its various Cases may carry out the object so far as possible of sweeping in profits not otherwise taxed....I am of the opinion that income derived by a trading company from investments of its funds, whether temporary or permanent, in Government securities must be taxed under Schedule C and cannot for the purposes of assessment under Schedule D be brought into account.'

On the other hand, the Revenue has on several occasions succeeded in its claim that investment income which is received without deduction of tax may, if it chooses, be included in the computation of profits under Case I. The most important judicial decision arose in the case of Liverpool and London and Globe Insurance Company *v.* Bennett.† In this case an insurance company resident and trading in the United Kingdom possessed certain foreign securities such as are dealt with by Case IV of Schedule D. The interest therefrom had been allowed to accumulate abroad and, that being so, under the Rules of Case IV, as they then stood, the Company was not liable to direct assessment in respect of any of that interest. In those circumstances the Company sought to have excluded from a statement of its profits and gains in its business the interest on those securities. In the Court of Appeal Lord Justice Fletcher-Moulton said: 'The formation of reserve funds out of the accumulation of premiums...is an essential part of the business of such a company and the dividends and interest from such investments form an integral part of its business receipts...the interests and dividends from these deposits and investments must be brought into account in ascertaining the balance of its profits and gains'; and, in the House of Lords, Lord Loreburn said: 'The only question here is whether the interest and dividends are profits and gains of this company's trade...within the meaning of the 1st Case. I think they are, upon the facts found by the Commissioners....And the Crown cannot be compelled to proceed under Cases IV or V if it prefers to proceed under Case I.'

The foregoing quotations have been given at some length in order to establish the important points (i) that although investment income of an insurance company may be regarded as a receipt of trade, such income, if taxed at source, must be excluded from a Case I computation of profits, and (ii) that investment income which is not taxed at source may, as the Revenue may choose, be directly assessed or included in the Case I computation of profits, but, if the Revenue assesses such income directly then it cannot also be included in the Case I computation of profits.

* (1930) (House of Lords) A.C. 432 and 15 T.C. 266.

† (1913) (House of Lords) A.C. 610 and 6 T.C. 327.

In dealing with the classes of business mentioned in paragraph 1, the Revenue usually chooses the option of direct assessment, and as such a procedure simplifies consideration of Case I, it will be assumed in what follows to have been adopted. We thus arrive at the conclusion that, all investment income having been taxed by deduction at source or by direct assessment, the entire investment income must be excluded in the computation of profits according to the Rules of Case I.

The conclusion, when put in this way, may give the impression of labouring the obvious. But this principle of Case I lies at the root of much of the obscurity and indirectness of income-tax law. So far as this point is concerned the same rule does apply to 'groceries' and to life assurance.

4. Case I. Actuarial Reserve

The case of Scottish Union and National Insurance Company *v.* Smiles* was conducted in a spirited manner. The Commissioners said that the difficulty of dealing with the profits of insurance companies was mainly due to an exaggerated importance attached to those elaborate actuarial calculations which they make for their own safety and guidance. The Commissioners also argued that if against the premiums received the Company puts the losses paid, the balance should be regarded as profit assessable to tax. They also pointed out that a net premium valuation makes a reserve for expenses. The Company replied vigorously and said that the Commissioners' contentions were 'unfounded and mischievous'. The Court decided that the profits and gains can be ascertained only by actuarial calculation, and this actuarial calculation may be obtained by taking the result of the quinquennial investigation prescribed by statute. Considered in conjunction with paragraph 3 the wording of the judgment does not seem to be quite clear, but at that date life assurance and fire and other insurance business formed one business for taxation purposes: the situation thereby caused is explained in paragraph 9, and it will be found that the judgment authorizes the statement that in the computation of profits the actuarial reserve for liabilities under life assurance contracts must be brought into account.

In the case of Last *v.* The London Assurance† the Revenue claimed that assessable profits should include additions made to the Life Fund, which were a transfer of income to capital. Mr Justice Day said that, in life assurance, each year's premium has relation to the whole duration of the life or risk and has to be set aside or capitalized for payment of the future debt; in no sense can the Life Fund, as such, be deemed to represent profit. Although the case proceeded to the House of Lords no appeal was made against the judgment on this point. The effect appears to be that in the profit computation the actuarial reserve at the beginning of the period should be credited and the actuarial reserve at the end of the period should be debited.

5. The Case I loss

From paragraphs 3 and 4 it follows that according to the Rules of Case I the profits of a valuation period are to be computed by crediting the actuarial reserve at the beginning of the valuation period, the premiums and the miscellaneous income received during that period (but not any investment income) and by debiting the claims, expenses and miscellaneous outgo of the

* (1889) (Court of Session) 2 T.C. 551.

† (1885) (House of Lords) 10 A.C. 438 and 2 T.C. 100.

period and the actuarial reserve at the end of the period. Subject to certain adjustments which will be discussed later the items other than the actuarial reserves will be the same as in an ordinary revenue account.

Such a method, when applied to the classes of business referred to in paragraph 1, will frequently (or even usually) result in a computed loss. This loss will be referred to as the Case I loss. It is evident that the Case I loss plus the omitted investment income must be equal to the actuarial surplus earned in the valuation period.

Since income tax is payable on the gross amount of income or profit before the application of tax, one of the adjustments to an ordinary revenue account consists in adding back the items of income tax already suffered, with the result that both the investment income and the actuarial surplus become 'grossed up'. As various statutory provisions which will have to be examined are of a complex character, it is proposed to ignore, for the present, all such practical complications, and it will be sufficient, while concentrating on the main principles, merely to remember that those complications exist.

6. Interest generally

The case of Clerical Medical and General Life Assurance Society *v.* Carter* is often quoted as authority for the statement that interest is taxable as such. Even apart from the fact that such a rule is subject to important exceptions (which do not apply to insurance companies) the statement does not convey the whole truth. The case concerned investment income which had been received without deduction of tax at the source and turned upon the words of Schedule D in the Income Tax Act of 1853, viz. 'the annual profits or gains arising or accruing from trade...and from all interest of money, annuities, and other annual profits and gains not charged by virtue of other schedules'. The corresponding words in the 1918 Act are almost the same. The essence of the case may be noticed in Mr Justice Manisty's words: 'The Act has made this (interest) taxable in the first instance and there is no means (in the circumstances of this case) of getting it back.' The Court of Appeal decided that, whatever may happen ultimately, interest is first taxable. The case decided nothing concerning what may happen afterwards.

7. Interest generally in conjunction with Case I

There are two items, each of which is separately taxable, viz. the investment income and the profit according to the Rules of Case I omitting investment income. In considering the underlying principles we can, for the present, ignore any modification on account of expenses or on account of profits allocated to policyholders. We can also ignore, for the present, the adjustments which have been referred to in paragraph 5.

Three different results can follow, viz:

(i) There may be a profit according to the Rules of Case I. This is probable in the case of fire insurance business, possible in the case of permanent sickness insurance business and improbable, but not impossible, in the cases of life assurance and sinking fund business. The situation is simple. The Case I profit must be taxed and the investment income must be taxed. The total tax payable is equal to tax on the earned actuarial surplus which, in such circumstances, will obviously exceed the investment income.

* (1889) (Court of Appeal) 22 Q.B.D. 444 and 2 T.C. 437. *J.I.A.* Vol. XXVIII.

(ii) There may be a Case I loss and the relevant law may prevent that loss from entering effectively into the taxpayer's tax settlement. The total tax payable is tax on the investment income, which, in such circumstances, must exceed the earned actuarial surplus.

(iii) There may be a Case I loss and the relevant law may not prevent that loss from entering into the taxpayer's tax settlement so that, in effect, tax can be recovered upon it. The net cost of taxation, including tax on all the investment income, is tax on the earned actuarial surplus.

The liability under (i) arises from a principle which has remained constant in time and in its application to all classes of business. If, for example, a closed life assurance fund happens, by reason of abnormally high surrenders, to have in a particular year a profit according to the Rules of Case I, then, in respect of that year, tax is payable on the investment income and on the Case I profit (i.e. on the investment income and on the excess of the earned actuarial surplus over the investment income) irrespective of the manner in which the account may be taxable if there were a Case I loss.

The liabilities under (ii) and (iii) are alternatives, and the law which results in one or the other becoming the effective liability has been neither constant from time to time nor comprehensive at any time. The Rules of Case I were conceived for the purpose of dealing with a profit, but, from the nature of life assurance and similar classes of business, the Rules often result in a computed loss which has an element of artificiality: to deal with that situation other provisions are introduced in an apparently arbitrary manner. In order to follow the subject further it is necessary to consider the law relating to Case I losses.

8. Rule 13. Cases I and II

This Rule provides that a person who carries on two or more distinct trades the profits of which are chargeable under the rules of Schedule D may set off a loss of one trade against the profit of another trade.

9. Section 34. I.T.A. 1918

Section 34, which dates from 1890, provides that where any person sustains a loss in any trade he may apply for an adjustment of his liability by reference to the loss and to the aggregate amount of his income estimated according to the Act: and provision is made for refunds in cash. This is a general section, and 'income estimated according to the Act' therefore includes investment income: under this section an ordinary trader could and can offset his trading loss against taxed investment income and obtain an appropriate refund of tax which had been suffered by deduction at source.

But, as regards all classes of insurance business and financial concerns generally, in which interest income can be regarded as an essential business receipt, it has been the practice of the Revenue authorities, with some degree of judicial support, to require that if a claim were made under Section 34 any loss would have to be computed on the basis of including all investment income as a receipt: such a practice generally destroyed any effective claim under Section 34 and, so far as that Section was concerned, left the insurance company in the position of suffering tax on its investment income.*

* Referring to classes of insurance business other than those under discussion in this paper, some very interesting remarks by Sir William McLintock on Revenue practice in relation to Section 34 will be found in Volume XXXVI of the *Journal of the Chartered Insurance Institute* (Feb. 1933).

Before 1915, when life assurance and fire and other insurance business formed one business for taxation purposes, a composite office, finding itself in the normal position of having a Case I loss in its life assurance business and a Case I profit in its other business, merged the profit and the loss in one computation, and, provided the profit covered the loss, it obtained, in effect, in respect of its life assurance business, result (iii) of paragraph 7, i.e. in effect it paid tax on the earned actuarial surplus. Such an office thus had no need to invoke either Rule 13 or Section 34 and was therefore unaffected by the Revenue practice under that Section. On the other hand, an office which transacted only life assurance and minor other business, finding itself in the normal position of having a Case I loss, was prevented by the Revenue practice under Section 34 from making any effective use of the loss and had to suffer result (ii) of paragraph 7, i.e. tax was payable on the investment income.

10. Rule 15. Cases I and II

The Revenue practice mentioned in paragraph 9 received statutory sanction, so far as life assurance business only is concerned, by this very important and rather obscure Rule which dates from 1915 and is still in force. The Rule provides that life assurance business shall be treated as a separate business, and that in ascertaining whether there is a loss for the purpose of setting off such loss against the profits of any other business (an apparent reference to Rule 13) or for the purpose of obtaining an adjustment of liability by reference to the loss and the aggregate amount of income under the Act (an apparent reference to Section 34), income derived from the investments of the life assurance fund shall be treated as part of the profits.

The first point to observe is that although the Rule is a Case I Rule it has no bearing on the calculation of assessable profits under the Rules of Case I. If it had, the injunction to include investment income would be a flagrant overriding of the rule against double taxation. Rule 15 confines such injunction to the computation of a loss for the purpose of setting off that loss.

The second point is that the Rule represents a marked departure from the original conception that all types of business could be treated alike. Under the Rule, life assurance is treated differently from 'groceries'.

The effect of the Rule is that, in life assurance business, whether it be transacted in conjunction with other classes of business or not, no effective use can be made of the Case I loss. Thus, so far as life assurance business is concerned, the Rule removes the difference in treatment of a composite office and a life assurance office which has been mentioned in paragraph 9. In both types of office the life assurance business becomes subject to result (ii) of paragraph 7, and not to result (iii). The practical effect of result (ii) has, however, been modified by other provisions.

11. Section 33. I.T.A. 1918

We have seen that, except in rare instances when there is a profit according to the Rules of Case I, the Rules relating to Case I losses result in life assurance business being subjected to income tax through the taxation of investment income and not by any other route. That remains true to-day, but Section 33, which dates from 1915, greatly affects the ultimate liability.

The Section provides in subsection (1) that an assurance company carrying on life assurance business or any company whose business consists mainly in the making of investments and the principal part of whose income is derived therefrom which has been charged to tax by deduction or otherwise and has not been charged in respect of its profits in accordance with the Rules applicable to Case I, shall be entitled to repayment of such tax paid by it as is equal to the amount of tax on any sums disbursed as expenses of management, including commission.

A proviso to the subsection adds that relief shall not be given under the Section so as to make the tax paid by the company less than the tax which would have been paid if the profits had been charged in accordance with the said Rules.

By virtue of Section 33 of the F.A. 1933 the amount of any relief which is disallowed by reason only of the proviso may be carried forward and treated as if it were an expense of management incurred in any of the six next succeeding years.

The intention of subsection (1), allowing for the effect of its proviso, is that, in the final result, the liability to income tax shall be tax upon the amount of investment income less expenses, or tax on the amount of the earned actuarial surplus,*. whichever basis shall yield the greater amount of tax. It may be observed that in neither alternative is there an actual assessment or charge of profits. If there were an assessment of profits the expenses would enter as a debit in the profits computation and could not reasonably be claimed again. What the subsection intends is that, tax having been suffered and there having been no assessment of profits, a claim may be made for repayment of tax according to the amount of management expenses. The intention of the proviso is so to limit the amount of repayment which can be obtained that, in the result, the company will have suffered an amount of tax on its investment income which shall be not less than the amount of tax computed upon its earned actuarial surplus.

The wording of the proviso is ambiguous and casts doubt on the meaning of the entire subsection. Life assurance profits computed in accordance with the Rules of Case I are usually negative. One reading of the proviso therefore is that the relief given by the Section shall not make the tax paid by the company less than nothing: such a reading makes the proviso ineffective in all cases. On the other hand, it may be said that if profits had been charged in accordance with the Rules of Case I, Rule 15 would have been applicable and consequently the Case I loss could not have been set off or otherwise effectively used, and, there being nothing to prevent taxation of the investment income by the usual processes of deduction at source and direct assessment, the ultimate result would have been payment of tax on the entire investment income with no effective right to recover any of the tax suffered: such a reading of the proviso completely defeats the principal provision of the subsection.

In the case of Simpson *v.* Grange Trust Ltd.† the wording of Section 33 caused the Courts considerable difficulty. Lord Justice Romer said that the subsection contemplates a case in which profits might be taxed under Case I, but in fact had not been so taxed: therefore, the word 'profits' in the subsection meant only profits which could be dealt with under Case I and no different meaning could be attached to the word 'profits' in the proviso. These remarks support the interpretation that the computation of profits for the purpose of applying the proviso is the ordinary Case I computation, which,

* Subject to 'adjustments'.

† (1935) (House of Lords) A.C. 422 and 19 T.C. 231. Briefly reported in *J.I.A.* Vol. LXV.

as has already been observed, would make the proviso ineffective so far as life assurance is concerned. Perhaps fortunately, the Court arrived at no binding decision on this point: as Grange Trust Ltd., an investment company, admittedly was not carrying on a trade assessable under Case I, the Court decided that the company was entitled to relief under the subsection and that the proviso has no effect upon non-trading companies.

In practice, both the life assurance offices and the Revenue have continued to carry out the original intention of the subsection, and in order to do so have assumed that the computation of profits, for the purpose of applying the proviso, is a computation in which all investment income is to be included. The computation is therefore not a computation of profits according to the Rules of Case I. Thus, there has become incorporated into the system of taxation of life assurance business a procedure which has no clear statutory basis.

A Case I computation of profits which is used not for the purpose of an actual assessment but by reference for other purposes, is commonly referred to as a notional Case I computation. As such a computation, when made with reference to life assurance business (and—see paragraph 13—post-1937 sinking fund business) does not wholly follow the Rules of Case I, it will be referred to as a special notional Case I computation. This special notional Case I computation, when made with reference to life assurance business, is now subject to modification by the effect of Section 16 of the F.A. 1923 on account of profits appertaining to policyholders.

12. Section 16. F.A. 1923

This section deals with the second major modification of the rules applicable to the taxation of life assurance business and should be read in conjunction with Section 33 of the 1918 Act. For the removal of doubt it declares that a mutual office is entitled to relief for expenses of management in the same manner as a proprietary office. It requires ordinary life assurance business and industrial life assurance business each to be treated as a separate business for taxation purposes and, in particular, Section 33 of the 1918 Act is to be applied to the two classes of business separately.

Apart from, and in addition to the foregoing, subsection (1) of Section 16 deals with life assurance business and subsection (2) with life annuity business. As Section 237 of the 1918 Act defines life assurance business as including annuity business, thus making them one business for taxation purposes, some care is necessary in order to avoid confusion. It follows from the definition that the profits of the annuity business of a company cannot be directly assessed without including in the profits computation the corresponding life assurance business of the company: the usual consequence would be the absorption of the Case I profit of the annuity business in the Case I loss of the life assurance business, and therefore it is usually impossible to assess annuity profits directly. Section 16 (2) provides indirectly for the taxation of such profits by requiring them to be deducted from the expenses of management allowable under Section 33 of the 1918 Act and, in effect, for this purpose, in spite of the general principle laid down in Section 237, annuity business is regarded separately from life assurance business. When, however, a computation of the profits of life assurance business is required, the general principle of Section 237 prevails and the life assurance business and the corresponding annuity business must be dealt with in one combined account. With the foregoing in mind we can proceed to the consideration of Section 16 (1).

The Royal Commission reported its view that actuarial surplus, in life assurance business, is not a true measure of trading profits for income-tax purposes and recommended that the basis should be 'the actual trading profit retained by the proprietary body'. Section 16 (1) does not entirely follow the basis recommended. The actual words in full are:

'Where the profits of an assurance company in respect of its life assurance business are for the purposes of the Income Tax Acts computed in accordance with the rules applicable to Case I of Schedule D, such part of those profits as belongs or is allocated to, or is reserved for, or expended on behalf of, policyholders or annuitants shall be excluded in making the computation, but if any profits so excluded as being reserved for policyholders or annuitants cease at any time to be so reserved and are not allocated to or expended on behalf of policyholders or annuitants, those profits shall be treated as profits of the company for the year in which they ceased to be so reserved.'

It will be noticed that the subsection refers to computed profits, thus including instances when the profits are not actually assessed. This fits the intended arrangement under Section 33 (1) of the 1918 Act. In order to make sense of Section 16 (1) it is necessary to adopt the same special notional Case I computation as is assumed in practice for the purposes of the proviso to Section 33 (1), i.e. a computation including investment income. That being so, it is perhaps not surprising that questions have arisen concerning Rule 3 (*l*) of Case I, which prohibits in the computation of Case I profits the deduction of any interest, annuity, or other annual payment which is payable out of such profits. Ordinarily the prohibition is the natural accompaniment of the right to deduct (and retain) tax from annual payments which are payable out of taxed profits, but, in relation to the special notional Case I computation when investment income is not only part of the trading, but is also, contrary to the Rules of Case I, included in the computation, the application of the Rule is not clear. In 1941 the Revenue suggested (actually in connexion with Section 9 (3) of the F. (No. 2) A. 1940, but that does not affect the principle under discussion) that the profits as ascertained by the special notional Case I computation and the application of Section 16 (1), viz. the remainder of the actuarial surplus after excluding the sums allocated to or reserved for policyholders or annuitants, should be augmented by an item not defined but described as 'interest paid away' and indicated as embracing such items as debenture interest and ground rents. Such a suggestion was not in accordance with the offices' understanding of the intention of Section 33 (1) of the 1918 Act as modified by Section 16 (1). Under Section 33 (1) the point in question arises only when the proviso to that subsection operates, whereby the whole of the investment income is freed from tax, except such an amount of it as is equal to the 'profits'. The profits of life assurance business as ascertained by the office do not include 'interest paid away', but neither does the sum total of investment income which, in practice, is presented for the process of being freed from tax under Section 33 (1), subject to the limitation which is imposed by the proviso. If the 'profits' are to include 'interest paid away', then the investment income should be presented with a similar inclusion, and the difference between the two quantities would be the same as before. It is the difference between the two quantities which is of primary importance, and in practice the Revenue has acquiesced in the offices' view.

The combined effect, as interpreted in practice, of Section 33 of the 1918 Act, of Section 16 of the F.A. 1923, and of the rules applicable to annuities or other annual payments which are paid out of taxed income, is that, in life assurance business, tax is suffered on an amount of investment income equal to the greater of two quantities, viz. either (i) the investment income (diminished by such life annuities and other annual payments as are paid out of taxed income) less life assurance and annuity expenses, plus annuity profits determined in accordance with Section 16 (2), or (ii) the balance of the actuarial surplus of the combined life and annuity account which remains after excluding sums allocated to or reserved for policyholders or annuitants in accordance with Section 16 (1).

The basis of the Section, which seeks to determine liability to tax not by reference to the profits which are taken by the 'proprietary body', but by first estimating the profits according to the Rules of Case I and then excluding sums appertaining to policyholders or annuitants, has caused much difficulty in practice. Some of the difficulties are inherent in the nature of Case I itself and will be considered in conjunction with the adjustments referred to in paragraph 5.

There is an important difference between the operation of subsection (1) and of subsection (2). The first subsection applies to a combined life and annuity account on occasions when an actual division of surplus between policyholders and shareholders falls to be determined; and usually some amount of surplus is carried forward undivided. The second applies to an annuity account which is often a hypothetical account: as annuity business only is involved the sums excluded from taxation are sums reserved for annuitants only, and, as in practice it is rarely the case that annuity contracts carry the right to participate in profits, usually no part of the surplus can be regarded as carried forward undivided: it follows that the underlying basis for taxation of 'profits' is, broadly, earned surplus less sums reserved for annuitants. With reference to Section 16 (1), however, it is the practice of the Board of Inland Revenue to regard surplus carried forward unallocated as a sum reserved for policyholders and annuitants: this practice has several important consequences, the point for present notice being that, subject to the adjustments referred to in paragraph 5, taxation is affected, not by the amount of surplus earned but by the amount distributed. In recent years, when a general distribution of profits has been postponed by many companies with the consequence that only trifling sums have been distributed to shareholders, the earned surplus has amounted to many times the amount distributed; and it does not seem an exaggeration to say that, in the absence of the Revenue practice just mentioned, the whole system of taxation of life offices would have broken down.*

13. Section 27. F.A. 1938. Post-1937 sinking fund business

This Section, which applies to such sinking fund business as relates to contracts effected after 31 December 1937, is drafted on the same lines as Rule 15 of Cases I and II. It requires that, for the purpose of setting off a loss under Rule 13 of Cases I and II or of relief under Section 34 of the 1918 Act, any loss shall be computed on the basis of including the income derived

* Consider, for example, paragraphs 18 and 20.

from the investments held in connexion with such sinking fund business. There is also a provision which makes such business a separate business for taxation purposes.

As sinking fund business, in practice, is regarded as falling within the meaning of the words 'consists mainly in the making of investments and the principal part of whose income is derived therefrom' which appear in Section 33 of the 1918 Act, the combined effect of that Section and of Section 27 of the F.A. 1938 is that post-1937 sinking fund business is taxable in the same way as life assurance business, with the exception that Section 16 of the F.A. 1923 does not apply to sinking fund business.

It is presumed that for the purposes of the proviso to Section 33 (1) of the 1918 Act, it will be found to be expedient to adopt the same special notional Case I computation of profits as is used in practice for life assurance business (i.e. a computation including investment income); accordingly, the relief for expenses of management will be limited so that the minimum liability will be tax upon the entire earned actuarial surplus.

At the present time, owing to the fall in interest rates, it is common to find a loss in post-1937 sinking fund business after the inclusion of investment income, and that loss may, it is admitted, be set off under Rule 13 of Case I or under Section 34 of the 1918 Act. In this respect, however, certain difficulties have arisen which will be referred to later.

14. Section 13. F.A. 1937

The Revenue practice mentioned in paragraph 9 has been terminated by this Section except in connexion with life assurance business and post-1937 sinking fund business.

The Section provides that for the purposes of Section 34 of the 1918 Act the amount of a loss sustained in a trade shall in all cases be computed in like manner as the profits or gains arising or accruing from the trade are computed under the rules applicable to Case I of Schedule D. It is expressly provided that Rule 15 of Cases I and II shall remain unaffected. The most important effect of the Section is that in all classes of insurance business, except the two classes just mentioned, and in all financial concerns which conduct a trade, a loss computed according to the Rules of Case I can now be set off against taxed investment income. This reversal of a long-standing practice has affected the taxation of pre-1938 sinking fund business (see paragraph 15) and of permanent sickness insurance business (see paragraph 16).

The change in principle is important.

15. Pre-1938 sinking fund business

The difference, before 1915, in the treatment of the life assurance business of a composite office and of a life assurance office has been described in paragraph 9. For the same reasons a similar difference existed in the treatment of the sinking fund business of the two classes of office.

Pre-1938 sinking fund business still forms for taxation purposes one business with fire and other general insurance business and, on merging the profit in such business with the Case I loss in the sinking fund business, the resultant tax liability of the sinking fund business is based on the earned actuarial surplus. Arrival at this result is, however, no longer dependent upon the existence of adequate profits in the fire and other business: if the company has a Case I loss in its combined sinking fund and other business it can now invoke

Section 13 of the F.A. 1937 and offset the loss against the taxed investment income. Thus, in either case, the tax liability attracted by the sinking fund business accords with result (iii) of paragraph 7. It will be observed, however, that there is a difference in the route by which this result is reached. In one case tax is payable on all the investment income and on the Case I assessment of the combined classes of business: in the other, after tax has been paid on the investment income, part of such tax is recovered. Therefore, when Section 13 of the F.A. 1937 is invoked, the statement of result (iii) of paragraph 7, viz. that 'the net cost of taxation, including tax on all the investment income, is tax on the earned actuarial surplus', although correct arithmetically, may not be sufficiently precise for all legal purposes, e.g. the purpose of determining whether a given item is payable 'out of profits and gains brought into charge'.

An office transacting only life assurance and sinking fund business can now invoke Section 13 of the F.A. 1937 in respect of its pre-1938 sinking fund business and so place the tax liability of that business on the basis of earned actuarial surplus.

The difference in treatment of the two classes of office has thus been removed, but by a different method from that adopted in 1915 for life assurance business. Taxation on the basis of earned actuarial surplus is much less onerous than taxation on the basis of investment income and, a considerable amount of business having been written in expectation of the smaller tax liability, it was probably judged inexpedient to impose the more onerous basis, especially at a time when an increase in the rate of income tax was to be expected.

Sinking fund business is not within the terms of Section 16 of the F.A. 1923, and therefore the basis of earned actuarial surplus is not subject to any modifications except the adjustments referred to in paragraph 5, which still remain to be considered.

16. Permanent sickness insurance business

Permanent sickness insurance business forms one business for taxation purposes with pre-1938 sinking fund business and general insurance business. The account which has been given in paragraph 15 of the effect of Section 13 of the F.A. 1937 upon the taxation of pre-1938 sinking fund business is equally applicable to permanent sickness insurance business. That being so, it is not now necessary to inquire why, when the permanent sickness account of a company which transacts only that class of business and life assurance business was taxed on the basis of result (ii) of paragraph 7, the permanent sickness insurance business was not regarded as a business 'which consists mainly in the making of investments etc.' within the meaning of Section 33 of the 1918 Act.

Permanent sickness insurance is not within the terms of Section 16 of the F.A. 1923, but a mutual company or society is allowed under Section 31 (3) of the F.A. 1933 to treat as an expense in the computation of its profits under Case I the actuarial cost of any bonus allocated to members, so that in effect the liability for tax, since 1937, is based upon that part of the earned actuarial surplus which is not immediately divided amongst members.

A new point arose in 1940 in the case of Forsyth *v.* Thompson* in which the Crown succeeded in a claim to assess, for the six years 1932–33 to 1937–38 inclusive, sick pay which had been received by a Dr Forsyth under a permanent sickness insurance policy at the rate of £6. 6*s.* 0*d.* a week during those years, on the ground that the payments were within the meaning of the words 'any

* 13 June 1940. King's Bench Division.

interest of money whether yearly or otherwise, or any annuity or other annual payment, whether such payment is payable...as a personal debt or obligation by virtue of any contract, or whether the same is received and payable half-yearly or at any shorter or more distant periods' in Rule 1 (*a*) of Case III of Schedule D. In fact, the Crown waived the decision in its favour in respect of the five years to 1936–37 and proceeded with the assessment only for the year 1937–38. Some light may be thrown on this waiver by considering the subject from the point of view of the insurance company, in this case a company transacting life assurance and permanent sickness insurance business only.

After the F.A. 1937 and before the Forsyth case the company expected to make the Case I computation of its permanent sickness account on the basis of omitting investment income and debiting benefits paid, and then to offset any resulting Case I loss against taxed investment income. When the result of the Forsyth case was known it appeared that Rules 19 and 21 of the General Rules applied. If the sick pay was not payable out of profits and gains brought into charge then the company was obliged under Rule 21 to deduct tax from the payment of sick pay and to account for the tax deducted, the result to the company being neither gain nor loss. If, on the other hand, the sick pay was payable out of profits and gains brought into charge then, under Rule 19, the company was entitled to deduct tax and to retain for its own benefit the tax deducted, but would, as a result, be unable to debit the sick pay in its Case I computation with a consequent equivalent diminution of the amount upon which it could recover tax.* Thus, provided the company exercised its right to deduct tax, again it would neither gain nor lose. Before 1937, however, the Case I computation did not enter into the company's tax settlement, and, to the extent to which sick pay was payable out of profits and gains brought into charge, tax deducted from payments of sick pay would have accrued to the benefit of the company.

Whether a payment is or is not to be regarded as having been made out of 'profits and gains brought into charge' is a question partly of law and partly of fact. The case of Gresham Life Assurance Society *v.* Styles† decided that a life annuity is not payable out of Case I profits. The principle elucidated in the case of The Lord Advocate *v.* Edinburgh Life Assurance Company‡ appears to be that if the insurance company has a pool of resources out of which the annuity or annual payment, not being charged on specific assets, may properly be paid and that pool includes investment income which has borne tax, the annuity or annual payment may, so far as the amount of the taxed investment income will permit, be regarded as having been paid out of such income and the tax deducted from the payment may be retained by the company. Rule 21 (3) of the General Rules, which restricts this right, does not apply to permanent sickness business.

It therefore seems that, before 1937, the company could have claimed that

* Hancock *v.* General Reversionary and Investment Co. Ltd. (1918) (King's Bench Division) 7 T.C. 358. Strictly, the decision was that in the Case I computation the company could exclude only the excess of the taxed investment income over the amount of the annuities which had been treated as paid thereout. Assuming all taxed investment income to remain excluded, the same result is reached by refraining from debiting such annuities.

† (1892) (House of Lords) A.C. 309 and 3 T.C. 185. *J.I.A.* Vol. xxx.

‡ (1910) (House of Lords) A.C. 143 and 5 T.C. 472. *J.I.A.* Vol. XLIV (and see the illuminating remarks by Lord Greene in Allchin *v.* Corporation of South Shields—Court of Appeal, May 1942).

sick pay not exceeding in the aggregate the amount of the taxed investment income of the sickness fund was payable out of profits and gains brought into charge. In such circumstances the Crown waived its claim in respect of the years up to 1937.

It is understood that, shortly afterwards, the Revenue announced its decision not to apply the principle of the case in practice except when sick pay continues to be payable for at least 52 consecutive weeks and, by arrangement, to assess the recipients direct.

17. Financial businesses. Option to tax interest or profits, whichever greater

It is not unusual to encounter a statement to the effect that the Revenue has an option to tax either investment income or profits, whichever may be greater. Any such statement, if found in a judgment, should be read with close consideration of the context; if it be found in any other source, where the language employed may reasonably be expected to be less precise, the appropriate attitude of mind is scepticism. A complex subject cannot be summarized accurately in one sentence. Paragraph 510 of the *Report of the Royal Commission* begins with these sentences:

'Under the present law Life Assurance companies are liable to bear tax either on profits (under Case I of Schedule D) or on the interest arising from the investment of their funds, whichever is greater. This alternative basis of liability is not peculiar to Life Assurance companies; it is common to all trading concerns.'

The first sentence was in 1920 broadly true (although not technically accurate) but the second was challenged by Mr Geoffrey Marks in his reservations (p. 145 of the *Report*) on the ground that it was not a complete statement of the case. The challenge has lost no force with lapse of time.

Profit according to the Rules of Case I rarely arises in a life office. When it does arise the resulting total liability cannot exceed tax on the actuarial surplus. Therefore, although we here encounter one aspect of the 'option', this liability, if isolated, would be unobjectionable; it is consistent, for example, with the liability of a fire insurance company.

We have seen that the Revenue possesses the powers (i) in some instances either to assess untaxed interest directly or to include it in the computation of profits under Case I, and (ii) in some instances to prevent a loss computed according to the Rules of Case I from entering into the taxpayer's tax settlement.

If there is a profit according to the Rules of Case I the total liability is unaffected whether interest be assessed directly or included in the profit (apart from the comparatively small point that an item of expense may be allowable by one route and not by the other). If there is a loss according to the Rules of Case I then direct assessment of the interest will increase the computed loss; if that computed loss can be merged with interest which has been taxed, again it makes no difference whether interest be assessed directly or included in the Case I computation: it follows that (i) can have no practical effect of general importance unless (ii) can also be brought to bear.

On the other hand, whether (i) exists or not, (ii) can have great practical effect since it gives the Revenue power to collect and retain tax on investment income whatever the circumstances may be, such power in the case of a life office resulting in taxation exceeding tax on the actuarial surplus.

As has already been indicated, the power of the Revenue under Section 33 of the 1918 Act is not clear. The Grange Trust decision appears to eliminate any 'option' in relation to companies which cannot be assessed under Case I for the reason that they do not conduct a trade. If, on the other hand, a business is of such a nature as to be assessable under Case I we are not concerned for the purposes of Section 33 with any case where there is a profit according to the Rules of Case I, omitting investment income: when there is a loss according to the Rules of Case I, the practice relating to life offices results, if the proviso to the Section applies, in taxation of a sum less than investment income and not exceeding actuarial surplus, and a similar result would follow generally unless the Revenue possesses power (ii).

The important part of the option is thus (ii) but, as has been seen, this power has been eliminated by Section 13 of the F.A. 1937 except in relation to life assurance and post-1937 sinking fund business. Whatever may have been the position in the period 1915–20, the force of the argument that 'This alternative basis of liability...is common to all trading concerns' has now disappeared. Life assurance and post-1937 sinking fund business are now treated differently not only from 'groceries' but also from any other financial business. No other business is now liable to tax on Case I profits and also liable to tax on investment income irrespective of Case I losses: this double liability, which is the essence of the 'option', appears to be quite indefensible: it is an unnecessary cause of obscurity.

18. Section 9. F. (No. 2) Act 1940

The onset of war in 1939 and the prospects of unprecedented taxation reawakened the thought that life assurance business, being liable to income tax on investment income which might be many times greater than the profits, could be rendered insolvent by the effect of the tax alone. It seemed that while many offices were, for various reasons, remarkably resistant to the adverse effects of high rates of taxation, nevertheless it was true that well-managed and well-established life assurance businesses could be placed in peril by very high rates of income tax.

The second Finance Act of 1940 increased the standard rate of income tax from 7*s*. 6*d*. to 8*s*. 6*d*. in the £ and Section 9 made new provisions relating to life assurance. By subsection (1), whenever the standard rate of income tax exceeds 7*s*. in the £, the rebate of income tax allowable to individuals in respect of their life assurance premiums is to be computed as if the standard rate were 7*s*. in the £: taken in conjunction with Section 32 (3) (*e*) of the 1918 Act which limits the maximum rate of rebate to one-half of the standard rate, subsection (1) results in limiting the normal maximum rate of rebate to 3*s*. 6*d*. in the £. Subsection (2) is a minor amendment. Subsection (3) provides that in respect of such part of the income from investments held in connexion with life assurance business as, in the opinion of the Commissioners of Inland Revenue, belongs to, or is allocated to or reserved for, or expended on behalf of policyholders, the company shall be entitled to repayment of any income tax paid or suffered in excess of the amount which would have been borne if the standard rate of income tax had been 7*s*. 6*d*. in the £: and subsection (4) provides that the computation under subsection (3) shall be made after allowing for other reliefs.

As the life offices had not made any suggestion concerning the manner in which life assurance business might be safeguarded, Section 9 represents the official view of what was appropriate; and the thought which is implied during the period in which the Section was being prepared seems to have been on the following lines, which accord with the Revenue views of 1919 as indicated in the Royal Commission's report: 'A life assurance fund is a collective investment of a number of individuals and the investment income is taxable even though it does not represent, except to a limited extent, profit in the hands of the office: if it be assumed that the investment income of the life assurance fund be appropriately spread over the incomes of the policyholders and taxed in their hands then, owing to changes in the incidence of income tax on individuals, the Revenue would now, to a much greater extent than in 1919, receive additional tax from the individuals at the full standard rate; further, if the increased liability to surtax be allowed for, it is almost certain that the total tax collectable from the individuals would be no less than the tax which is now collected from the offices: therefore, whatever may have been the situation in 1919, there is no basis in present circumstances for applying to a life assurance fund a rate of tax less than the standard rate: on the other hand it is not reasonable to return to the individual, by way of tax-rebate in respect of his premiums, larger and larger percentages of his premium and to omit protecting the fund which is the basis of the assurance for which he is paying the premium: therefore, although there is no justification for granting to life assurance business a differential rate of tax, it is inexpedient to permit contemplated increases in the rate of tax to apply to that portion of the investment income which enures for the benefit of policyholders; and no concession is required when the special notional Case I computation is effective because, in such a case, taxation applies only to a sum equal to profits and not to an amount of investment income in excess of profits.'

If, as is believed to be the case, the foregoing represents a fair summary of official views, it follows that the 7*s*. 6*d*. rate of tax is an arbitrary rate based upon what was considered to be expedient.

As the determination of that portion of the investment income which appertains to policyholders depends upon the opinion of the Commissioners of Inland Revenue, there is no right of appeal to the Courts on this point. The Commissioners have decided that, subject to certain points of detail, the amount is to be determined by the following formula, viz. $I-E-D$, where I represents the amount of the investment income of the life assurance and annuity fund which has borne tax at the standard rate (the amount being ascertained before deduction of tax but after deducting interest paid away and after deducting the amount of annuities from which the office is entitled to deduct and retain tax), E represents the amount of management expenses adjusted in accordance with Section 33 of the 1918 Act and Section 16 (2) of the F.A. 1923 upon which tax at the standard rate will have been allowed, and D represents the amount of the special notional Case I computation of profits of the combined life and annuity fund for the purposes of Section 33 of the 1918 Act as modified by Section 16 (1) of the F.A. 1923.

At first sight it may seem odd that the item D should be the item chosen to represent that portion of the investment income which does not appertain to policyholders, but reflection will show that it is not unreasonable: surplus is not the same thing as investment income but, in a given account, for every £1 of surplus there will be, say, £x of investment income, and it follows from the nature of the case that £$(x-1)$ of investment income must appertain to policyholders and either be paid to or reserved for them. If there is no surplus the formula correctly indicates that all the investment income must appertain to policyholders and the formula is also correct in the case of mutual offices, in which it is agreed that the item D is always *nil*: when the item D is a negative quantity the relief in that year is restricted to the quantity $I-E$, but the negative value of D may be carried forward into subsequent computations of D: when the formula $I-E-D$ results in a negative quantity no relief is allowable. The present method of taxing profits of annuity business, whereby annuity profits are deducted from the expenses of management which attract relief of tax upon a corresponding amount of the investment income of the life assurance fund, has the effect of treating annuity profits as part of that income. The formula $I-E-D$ allows for this point. The item E will have been reduced by the entire annuity profits which have not been reserved for annuitants, and, as item E enters negatively into the formula, those annuity profits enter positively into the total upon which relief is allowed: from such annuity profits are deducted, included in the item D, all annuity profits which do not appertain to the combined body of life assurance policyholders and annuitants. Therefore relief is allowed, in effect, upon such annuity profits as belong to life policyholders.

It is considered that the practical interpretation of Section 9 (3) which has been laid down by the Commissioners is appropriate in the present state of the law and that any valid criticism will be found to be directed not against the interpretation itself but against the nature of the Case I computation which leads to the item D. The right of appeal to the Courts on points concerning a Case I computation remains.

19. Trading profits

We have now reviewed the principal statutory provisions which relate to or are affected by the principles of Case I, and it is noticeable that the survey has included every part of the main structure of the taxation system applicable to life offices. What is even more evident is the complete absence of any rational and coherent system of arriving at the amount of trading profits for taxation purposes.

The Royal Commission, after indicating the difficulties inherent in life assurance business (e.g. that surplus depends on valuation basis) concluded that fortunately such difficulties were of little moment when the actuarial surplus affected the liability to tax only to the extent that it determined the share of profits accruing to the proprietary body, and when that share of profits was (except in industrial assurance) seldom the basis of the actual charge. The F.A. 1923 and the F.A. 1933 (see paragraphs 12, 16 and 21) dealt with the point that bonuses to policyholders represent mainly a return to them of their own money, but otherwise the problem of determining trading profits has remained unsolved. It is doubtful whether it is soluble; but it can no longer be dismissed as being seldom of practical importance. Both annuity business and industrial assurance business, which are affected by Case I, have grown; the F.A. 1923 does not plainly restrict taxation to the sums which accrue to the proprietary body; since 1940, the majority of ordinary life assurance companies are affected by Case I, because of the F. (No. 2) A. 1940; and, with income tax at 10*s*. in the £, significant liabilities for tax can be incurred in the relatively smaller sinking fund and permanent sickness insurance accounts, most of which also are now affected by Case I.

Questions arise concerning such matters as the appropriate treatment of a change in the basis of an actuarial valuation, depreciation in the value of investments, and other important items which, in this paper, have so far merely been referred to as 'adjustments'. Businesses to which actuarial valuations apply involve the existence of funds many times greater than the annual premium income and therefore the 'adjustments' can, and sometimes do, involve sums of money much larger than any reasonable estimate of normal trading profits.

20. Case I. Adjustments

General remarks. It is not intended to discuss the detailed corrections of the revenue account of a particular office which may be required in order to arrive at a standard revenue account: in practice many such corrections can be disregarded in life assurance business because an alteration in the amount of the fund and therefore of the surplus would, in many cases, be counterbalanced by an equivalent alteration in the amount of surplus carried forward undivided: in any case such 'adjustments' are comparatively insignificant. All the 'adjustments' to be considered are items which the Revenue claims to disallow as debits in the computation of profits according to the Rules of Case I. Although disallowance is determined by Case I principles (modified, when applicable, by Section 16 of the F.A. 1923) consideration of an 'adjustment' usually arises in practice after investment income has, either actually or in effect, been brought into account and therefore the adjustment is an augmentation of the actuarial surplus. In this paragraph actuarial surplus, or such surplus as modified by Case I principles and by Section 16 of the F.A. 1923, will, for the sake of brevity, be referred to as taxable profit and it should be borne in mind that 'taxable profit' is not an accurate term, sometimes because there is nothing to tax until after investment income has been brought in and sometimes because there is no direct charge on profits.

Change of valuation basis. The Rules of Case I are silent concerning the valuation of liabilities. Even so elementary a matter as a reserve for the unexpired risks in a fire insurance account required consideration by the House of Lords. In the case of Sun Insurance Office *v.* Clark* Lord Loreburn said: 'A rule of thumb may be very desirable but cannot be substituted for the only rule of law that I know of, viz. that the true gains are to be ascertained as nearly as it can be done.' The case of Scottish Union and National *v.* Smiles, which has already been referred to, established that, in order to ascertain true gains, an actuarial valuation is necessary; but the case did not involve judicial consideration of a change in the basis of that valuation.

There are certain points common to all classes of business which involve an actuarial valuation. The trades conducted are trades in the rate of interest or in the rate of interest and various contingencies, and the contracts are for the duration of life or other long terms: at any valuation date the great majority of the contracts which were in force at the previous valuation date remain undetermined. As the outcome of the uncompleted contracts is unknown it is inherently impossible to find any measure of profits except an estimated amount which depends upon the present value at the valuation date of the liabilities under the uncompleted contracts and is, almost wholly, unrealized profit: the ascertainment of that present value necessarily involves estimating the net rate of interest, the rate of expense and the rates of mortality or other contingencies which will be applicable in the future. These facts do not fit the

* 1912 (House of Lords) A.C. 443 and 6 T.C. 59.

framework of Case I which, broadly, contemplates a computation of annual realized profit. Inspectors of Taxes tend to regard an actuary as making an unallowable provision for contingent or future losses when he is merely placing a present value or a revised estimate of a present value upon a contractual liability, and they are also apt to forget the inherent nature of the computed profits so that a loss appears to them to be unreal. They sometimes conceive it to be their duty to ask many questions concerning the bases of actuarial valuations and fail to appreciate the interaction of the various factors which are involved. The Revenue agrees in principle that an increased stringency in actuarial reserves may be justifiable and, in approved cases, the increase in reserves arising from the change of valuation basis is excluded from taxable profits. It nevertheless claims the right to consider each instance separately, and, if it thinks fit, to determine taxable profit as it would have been if the valuation basis had remained unchanged. Although in practice, in recent years, numerous instances of increased stringency in actuarial reserves have been approved, efforts to arrive at a statement of the principles upon which approval may be expected have failed.

Fortunately, so far as life assurance business is concerned, the valuation basis is of little practical importance: it seems that the actuarial reserve must be a sum reserved for policyholders within the meaning of Section 16 (1) of the F.A. 1923 and, as surplus carried forward undivided is admitted to be reserved for policyholders, the actuarial reserve may be increased and the carry-forward correspondingly diminished without affecting the total amount which is reserved for policyholders and therefore excluded from taxable profits.

Section 16 (2) of the F.A. 1923 provides that sums reserved for annuitants shall be excluded from taxable profits. It does not follow that the additional reserve resulting from a change to a stronger valuation basis will automatically be allowed as a sum reserved for annuitants: consideration of each instance applies. Further, the Revenue attitude is that since an exclusion of profit under Section 16 (2) cannot turn a profit into a loss, an increase in actuarial reserves can be allowed only so far as such increase can be made out of annuity profits. It is however admitted that if, at one valuation date, the increase in actuarial reserve exceeds available annuity profits, it will follow at subsequent valuation dates that annuity profits available then may be excluded from taxable profits by regarding them as applied then to the setting up of the increased reserve. This admission meets the major objection that double taxation could be involved by disallowing a loss incurred in increasing a reserve and by disregarding the influence of that reserve upon the magnitude of subsequent profits and losses.

It will be observed that Section 16, which applies only to life assurance and annuity business, enables the underlying difficulties of Case I to be evaded to some extent but leaves them unsolved.

Realized profit or loss on investments. The usual rule is to bring such items into the computation of profits, the basis for measuring the profit or loss being the difference between cost and the sum realized on the sale or redemption of an investment, subject to adjustment of such difference by such expenses of sale or realization as may have been allowed as expenses of management. The most important modification of the usual rule arises under Section 16 (1) of the F.A. 1923 whereby some offices successfully claim that realized profits or losses appertain to policyholders and therefore must be excluded from the computation of taxable profits. Offices generally have acquiesced in the

Revenue view that such profits and losses must be brought into account in computing the profits of annuity business under Section 16(2) of the F.A. 1923 and in computing the profits of sinking fund and permanent sickness insurance business.

Some offices conduct their business in such a manner as to involve, in fact, trading in investments. It is however possible, without involving trading in investments, to make substantial changes in holdings provided that the motive is the preservation of the value or yield of the whole. The practice of some offices may be more nearly described as holding investments rather than trading in them. In some instances it may be advantageous to consider closely whether it is possible, by attention to details of practice and to that part of the constitution which relates to classes of business which are separate businesses for taxation purposes, to rebut any suggestion that trading in investments is involved.

Investment reserves. Sums written off in excess of actual depreciation. Hitherto the Revenue has claimed that any sum written off the book value of investments or carried to an investment reserve must, to the extent to which such sum relates not to any existing (realized or unrealized) depreciation in the value of investments but creates a reserve for possible future depreciation, be disallowed as a debit and therefore included in taxable profits.

This claim is not now contested except in connexion with the profits of life assurance business under Section 16 (1) of the F.A. 1923: in that connexion numerous offices claim that there is no room for doubting that their investment reserves are, in fact, sums reserved for policyholders. The reserves referred to are entirely independent of sums due to shareholders, are not applicable to the general purposes of the company and, in the view of the company, are applicable to its ordinary life assurance business only or to its industrial assurance business only.

Although some such investment reserves have been allowed by the Revenue as sums reserved for policyholders, the subject remains undetermined in principle. The Revenue appears to be apprehensive that indirectly some benefit may accrue to shareholders. It is difficult to find any ground of general importance for such apprehensions. A liquidation of a life office while the life assurance business is solvent is admittedly not impossible, but Section 16 (1) refers to what is now reserved and renders taxable in the future any sum which may then cease to be reserved for policyholders. Alternatively, assuming the much more likely case of a continuing business, the impression exists that the effect of the prohibition in the Assurance Companies Act against applying any part of any fund, directly or indirectly, for any purpose other than the class of business to which it is applicable, has been undervalued by the Revenue. Moreover, frequently, further protection of the interests of policyholders is given by constitutional limitation of the rights of shareholders (the business thus being little different from that of a mutual office) or by voluntary segregation of the assets of the life assurance fund.

Depreciation of investments. 'Actual' but unrealized. The general rule is that a sum relating to depreciation of investments is not a permissible debit in the computation of profits. In the case of Irish Catholic Church Property Insurance Co. Ltd. *v.* The Commissioners of Inland Revenue* the Court held that no obligation was imposed by the Assurance Companies Act upon the company

* 1918 (Court of Appeal—Ireland) 12 T.C. 13.

to make good the depreciation in the value of its securities and the company also failed in its contention that its principal business consisted in the making of investments. In the case of The Royal Insurance Company Ltd. *v*. Stephen* Mr Justice Rowlatt said '...while an investment is going up or down, for income tax purposes the company cannot take any notice of fluctuations'. In both cases general insurance business only was involved. The law is thus plain, but in relation to such a business as sinking fund business, which does consist mainly in the making of investments and could be rendered insolvent by the disallowance of depreciation, it cannot be said to be reasonable. The Revenue has made the concession that if, in a sinking fund account, whether pre-1938 or post-1937, profit is created by the release of actuarial reserves and depreciation is written off by the application of such profit, then, to such extent, 'actual' depreciation will be allowed: an indication has also been given of willingness to consider granting a similar concession in relation to permanent sickness insurance business which, in principle, is also in jeopardy of insolvency by the disallowance of depreciation.

'Actual' depreciation is defined as the extent to which the aggregate market value of all investments of the appropriate fund (not merely Stock Exchange investments) shrinks below aggregate cost during the valuation period to which the surplus relates.

In the Revenue view 'actual' depreciation is allowable as part of profits reserved for life assurance policyholders and annuitants within the meaning of Section 16 (1) of the F.A. 1923, and also, under Section 16 (2), as part of the profits reserved for annuitants: thus, depreciation is not allowable in excess of available profits so as to involve a loss admissible for taxation purposes, nor is it allowable if not written off or not covered by investment reserves, and, for the purposes of determining the maximum amount of depreciation which could be allowed in respect of a valuation period, the profits of that period are to be computed before the deduction of depreciation. The Revenue also claims that if depreciation be allowed and appreciation subsequently occur, then appreciation not exceeding the amount of depreciation allowed must be brought into taxable profits. The precise application of these principles to successive valuation periods of annuity business under Section 16 (2) awaits further consideration. In connexion with life assurance business, however, the claim to bring in appreciation does not appear to be consistent with the claim of the offices to be allowed investment reserves as sums reserved for policyholders, nor with the rule that surplus carried forward undivided is regarded as reserved for policyholders.

Other items. The foregoing, relating to the value of the liabilities and the assets, comprises the major items, but there are others which have caused difficulty. Actuaries cannot understand why a reserve for the expenses which will be incurred in paying such staff pensions as are fairly chargeable to the life assurance fund should evoke no comment if included in the reserve for expenses which is made by the actuarial valuation, but should be disallowed if set aside as a separate item in the balance sheet: they also fail to follow why an item of expense which is disallowed because it is of a capital nature should therefore necessarily be regarded as appertaining to shareholders for the purposes of Section 16 of the F.A. 1923.

'Grossing up.' The adding back of items of income tax already suffered

* 1928 (King's Bench Division) 14 T.C. 22.

presents no difficulty except in life assurance business where it is necessary to determine the amount of income tax paid or suffered, which, under Section 16 (1) of the F.A. 1923, is to be regarded as having been paid on behalf of policyholders. The method now used is to regard the taxable surplus expressed as an amount per annum, before income tax is added back, as analogous to an annual salary free of tax, to add back tax accordingly, and to regard all tax paid or suffered, except such amounts added back, as appertaining to policyholders.

21. Mutual Offices

In the case of Cornish Mutual Assurance Co. Ltd. *v.* Inland Revenue* it was held that the case of New York Life Insurance Co. *v.* Styles† did not settle that such a company did not carry on a trade but merely settled that it did not make taxable profits. In the case of Inland Revenue *v.* South West Lancashire Coal Owners Association Ltd.‡ it was held that although a company could make a profit from trading with its members as customers, where, as in the New York Life case, money was simply collected from one set of people and handed back to them as their right in the character of the people who had paid it and not in the character of shareholders, there was no profit (the necessary condition being that the interest in the money did not go beyond the people who had subscribed it or the class of people who had subscribed it). These principles were confirmed by Section 31 of the F.A. 1933 which was enacted as a result of reconsideration of the position of co-operative societies. The Section provides that trading profits chargeable under Case I shall include the profit arising from the transactions of any company or society with its members as if those transactions were with non-members, but there may be deducted, in the course of computing the profits, any dividend or bonus granted by the Society whether to members or non-members provided that the dividend or bonus be granted by reference to the amounts of their transactions and not otherwise.

It follows that the non-profit sinking fund business of a mutual office is chargeable under Case I (when applicable). Since it is agreed that the whole of the profits of the life assurance business (including annuity business) of a mutual office are regarded under Section 16 (1) of the F.A. 1923 as reserved for policyholders and annuitants, there can be no charge under Case I in respect of annuity business except the indirect liability which is imposed by reduction of the relief for management expenses. Neither can the general principle of Section 31 be applied so as to render chargeable under Case I any other non-profit business which forms part of the total life assurance business, because the whole of such business is one unit for income-tax purposes.

22. Income Tax Codification Committee's Report, 1936. (Cmd. 5131)

This *Report* contains some well-founded general remarks, e.g. 'The provisions of a large part of the existing law have remained unaltered since they were drafted over a hundred years ago....The Legislature, by adding a patch here and there, the Courts by interpreting particular provisions, and the Inland Revenue Department by devising practical expedients have enabled the system

* 1926 (House of Lords). *J.I.A.* Vol. LVII.

† (House of Lords) 14 A.C. 381 and 2 T.C. 460. Referred to by J. E. Faulks, *J.I.A.* Vol. XXXVIII, p. 317.

‡ 1926 (Court of Appeal). *J.I.A.* Vol. LVII.

to continue....There is no general direction as to how business profits are to be ascertained....High rates (of tax) have necessitated the introduction of alleviations in the interests of various classes of taxpayers....The space occupied by the provisions relating to such reliefs and exemptions is now prodigious....The method of income-tax legislation since 1907 might not inaptly be described as one of improvization....It is not too much to say that, were it not for the good sense and reasonableness shown by the (Inland Revenue) Department in the practical application of our income-tax system, and in devising expedients for making good its deficiencies and omissions, it would at many points have proved unworkable....The tax affects every... phase of the nation's multifarious economic activities....Each of these activities...has its own special characteristics calling for special treatment adapted to its individual case....The limits of the powers conferred upon us by our terms of reference ("leaving substantially unaffected the liability of the taxpayer") have...operated...to prevent us from attaining the desired uniformity and simplicity.'

The draft Bill accompanying the *Report* contributes little towards clarification of the law affecting life offices. The arrangement of the statutory provisions is greatly improved and the phraseology is simpler and more direct, but the entanglement of principles is unchanged. Subject to certain express provisions the draft Bill lays down the statement that Case I profits 'shall be computed in accordance with the ordinary commercial principles applicable to the computation of profits of that business': in some aspects this statement might be helpful: in connexion with the relation of investment income to Case I profits it may be merely an additional source of confusion. The attempt to simplify phraseology is not without its dangers. For example, Section 16 (1) of the F.A. 1923 is redrafted not with the appropriate words 'where the profits... are computed...' but with the words 'Where...an assurance company carrying on life assurance business is charged with tax...' (these words being followed by revised wording showing that the charge referred to is a charge under Case I) and the meaning is consequently not clear: and Section 33 of the 1918 Act is re-enacted in several separate sections, one referring to life assurance business, one to investment companies and one to savings banks, a procedure which raises doubts concerning sinking fund business. Generally there is no recognition of the obscurities involved when interest is a subject of the trade but is separately charged.

23. N.D.C. and E.P.T.

Each of these taxes is a tax on profits which are to be computed (whether or not the charge to income tax is affected by Case I) upon such income-tax principles as apply to Case I, subject to numerous modifications, the most important being (i) omission of the rules relating to interest, annuities and other annual sums payable out of profits and (ii) in the case of assurance business, but not in the case of an ordinary trader, the inclusion of investment income in the computation of profits.

N.D.C. is imposed by the F.A. 1937 as amended by the F.A. 1938 and the F.A. 1939: E.P.T. is imposed by the F. (No. 2) A. 1939: amendments applying to both taxes and the relation between them appear in the F.A. 1940 and further amendments are included in the F. (No. 2) A. 1940, the F.A. 1941 and the F.A. 1942. Complicated provisions deal with the application of the two taxes to different classes of business and to principal and subsidiary companies, the intention being that in the final result there shall be payable by a group of companies whichever of the two taxes shall result in the greater aggregate over a period: other provisions relate to the determination of standard profits for E.P.T. purposes and the variation of standard profits in relation to fluctuations in the amount of capital employed in the business.

This complex body of legislation has caused the life offices a large amount of work which is quite out of proportion to the probable yield of the taxes. The determination of life assurance 'profits' at intervals of a number of years and the aggregation of classes of business and of principal and subsidiary companies render impossible any present demonstration that life assurance and allied classes of business will have little effect on the yield of E.P.T., but the contribution of such businesses to N.D.C. will certainly be small and if, as is currently common, an ordinary life office makes no general distribution of profits, the amount of N.D.C. payable is of the order of a one-thousandth part of the income tax payable by the life assurance business.

As regards N.D.C., the prospect of either small or trifling liability might have led to some practical basis of settlement which would have avoided many of the troublesome points involved, but such a course is unacceptable in relation to legislation based upon income tax principles because of possible reflection on the far greater liability to income tax.

Bearing in mind the obscurities of Case I and the warning given by the Royal Commission in 1920 concerning the difficulties inherent in its application to life assurance business, many actuaries regret that such a superstructure as N.D.C. and E.P.T. should have been erected upon such a weak foundation. The fact that the two taxes are supposedly temporary, but have nevertheless been imposed upon businesses consisting of long-term contracts, has added to the problems; for example, a change in the basis of an actuarial valuation cannot be considered properly by regarding a period of only a small number of years.

The legislation was evidently ill-considered in relation to life assurance business. Paragraph 2 (1) of the Fourth Schedule to the F.A. 1937 appears to make the Case I loss an admissible loss for N.D.C. purposes and is amended retrospectively by Section 36 of the F.A. 1939. The conception that life assurance business in time of war and in a period of low rates of interest should be subjected to E.P.T. is itself odd; the conception that the 'profits' of the business could vary in any relation to its 'capital' is stranger still; and the provisions relating to the computation of that 'capital', as amended by Section 34 of the F.A. 1940, which appear to make 'capital' vary in relation to the amount of 'profits' as computed under Section 16 (1) of the F.A. 1923, can only have been drafted in conditions when time was inadequate to allow reflection.

Two points are worth remembering in relation to any income-tax legislation of the future. The first is the view initially taken by the Revenue, but afterwards abandoned, that N.D.C. is applicable to the annuity business and to the non-profit life assurance business of a mutual office: the importance of the extent to which business is divided into separate sections for taxation purposes has been indicated in paragraph 21. The second is the Revenue view that the investment income of a life assurance business is not necessarily equal to the investment income of the life assurance fund; as life assurance business is subject to special treatment it seems desirable, for the avoidance of confusion, that tax legislation directed to the investment income should plainly relate to the investment income of the fund: a similar point applies to allied classes of business.

It is considered that N.D.C. and E.P.T. should have been declared not applicable to life assurance business and allied classes of business as such, and that the taxes should have been applied solely to sums enuring to the benefit of shareholders, or of other classes of policyholders, as such sums become available to the transferees. The main lesson to be learned is the need for some arrangement which will ensure that proposed legislation shall be adequately considered before it reaches the Statute book.

24. Income Tax. Suggested amendments

The present confusion is intolerable. Legislation appears to be necessary to establish a coherent basis. A completely satisfactory basis is probably unattainable. The following proposals are limited to what appears to be practicable.

(*a*) *Life assurance business and post-*1937 *sinking fund business.* These two classes should be taxed similarly. At the end of paragraph 13 reference has been made to losses in post-1937 sinking fund business. The Revenue has pointed out that the allowance of a loss might operate unfairly against the Revenue if the business subsequently becomes profitable and then taxable on the basis of interest less expenses. Reluctance to admit a loss is, however, inconsistent with the claim to collect tax on surplus when surplus exceeds investment income; moreover the taxation of investment income normally operates so as to tax profit also. Throughout income-tax legislation there is either no recognition or insufficiently clear recognition of the fact that two separate interests exist, viz. those of policyholders and those of the company. Another cause of confusion is the 'option' to tax investment income or 'profits'. There is no sound reason why the 'option' should continue and it should be eliminated: reasons are given below for the view that the offices must accept taxation of investment income: it follows that liability under Case I should be abolished. Any given method of taxing investment income may be denoted as $(I-E)$ which becomes the total quantity arising each year for subjection to tax. All difficulties concerning values placed on liabilities and assets disappear but the division of $(I-E)$ between policyholders and shareholders remains to be settled. To ensure clarity the division should be between the appropriate assurance fund (maintained in accordance with the principles of the Assurance Companies Act) and the company: sums appertaining to the fund will be all those which have been applied or continue to be applicable only for the purposes of the fund and sums appertaining to the company will be all those which have ceased to be bound by that rule whether such sums be transferred to Profit and Loss, to other classes of policyholders or otherwise. Let such sums be denoted by T. Then the fund should each year become liable for tax on $(I-E-T)$ and the company should each year become liable for tax on T. The quantity $(I-E-T)$ represents the income of the policyholders' collective investment: no question of loss arises: any negative value could be carried forward on the principles of Section 33 of the Finance Act 1933 in potential reduction of future liability of the fund. When T is positive the company should be liable to pay tax on T notwithstanding that $(I-E-T)$ may be negative. When T is negative, implying support of the fund by the company, that fact will tend to increase $(I-E-T)$ and the fund must accept the effect on its tax liability: tax should be refunded by the Revenue to the company on any positive value of (I – E – T) for that year not exceeding T, and any remainder of T not so relieved should be carried forward in potential reduction of future liability of the company. In all circumstances the aggregate result each year in liability or contribution to sums carried forward is (I – E). As a transfer from the company to the fund will have an effect on future values of T, negative values of T should be allowed to be carried forward without time limit.

The following are incidental points, viz. (i) The right of post-1937 sinking fund business to relief for expenses of management should be explicit. (ii) The processes described in the preceding paragraph should be carried out with reference to the standard rate of tax before any modification of the fund's liability is applied. (iii) If the item T contains any sum 'free of tax', for example a share of divisible surplus, that sum will need to be grossed up. (iv) After (ii) has been performed there is no obstacle to the application of Section 9 (3) of the F. (No. 2) A. 1940 or any other similar modification.

The reasons why it is thought that offices must accept taxation by some method based on investment income are (i) the opinion of the Royal Commission that no contracts entered into by a subject should be permitted to dispose of taxable income in such a manner that the State is deprived of tax on that income, (ii) sustained attempts by taxpayers to make use of life assurance for the purpose of tax avoidance, (iii) the argument that taxation of investment income can cause insolvency has less force than formerly because official recognition of the need for practical care has been given by Section 9 (3) of the F. (No. 2) A. 1940, and (iv) the serious difficulties inherent in any method based on profits. The policyholders' rebate of tax on premiums is a connected subject: it is not thought to be expedient to advocate its abolition; it rests not on any logical basis but on custom, and therefore its abolition will not necessarily contribute to the solution of the taxation problems of the policyholders' assurance funds: on the other hand, the common-sense need for its limitation has already been recognized and there is no reason why modifications should be ruled out: incidentally it would be just, in future modifications, to improve, in relation to the taxpayer of large income, the benefit of the taxpayer of small income whose share in the 'collective investment' of premiums is comparatively over-taxed.

Present taxation of investment income less management expenses presses heavily on the long-established well-managed office and it is difficult to justify the comparatively light liability of rapidly expanding funds which include those of some Dominion offices and some ordinary departments of industrial offices. The suggestion has been made that taxation at some rate less than the standard rate should be applied to investment income and that management expenses should be ignored. If ordinary life assurance only were involved the suggestion would deserve close consideration, but it would seriously disturb industrial life assurance which represents a 'collective investment' of policyholders whose individual tax liability is either nil or comparatively small and therefore should, as is now the case, be taxed comparatively lightly.

There remains the suggestion that the policyholders' rebate of tax on premiums should be limited to a normal maximum of one-third of the standard rate of tax and that the investment income less management expenses of life assurance funds should be taxed at, say, two-thirds of the standard rate. This is little different from the present effect of Section 9 of the F. (No. 2) A. 1940 but is worth remembering for the future: the proportions of the standard rate which are involved are not immutable.

(*b*) *Pre-1938 sinking fund business, permanent sickness insurance and life annuity business.* The primary need is amendment of the Rules of Case I, with reference to the respective funds (i) requiring the importation into the computation of profits of all untaxed investment income and of the excess, if any, of taxed investment income over interest, annuities or other payments which are treated as having been paid thereout, and (ii) providing a discharge of liability under all other Schedules and Cases in respect of all investment income so imported. Such an amendment will banish the artificialities of the present Case I loss: owing to the effect of Section 13 of the Finance Act 1937 it will have no effect on the ultimate tax liability of pre-1938 sinking fund business or of permanent sickness insurance business: life annuity business would however be favourably affected, in cases when any investment income falls to be so imported, because a Case I loss, as computed at present, can only be carried forward, an anomaly which places a life office transacting large amounts of superannuation business in an unfavourable position compared with private schemes.

A point which requires close consideration by the offices is whether or not it is advisable to make life annuity business a separate class of business for taxation purposes. At present it follows from the definition of life assurance business in Section 237 of the 1918 Act that any claim to set off, under Rule 13 of Cases I and II or under Section 34 of the 1918 Act, a loss in life annuity business, could be made only if there were a loss after the inclusion of life assurance business; and the necessary inclusion of investment income under Rule 15 of Cases I and II would destroy, in nearly all cases, the possibility of making an effective claim. On the other hand, annuity profits, as determined under Section 16 (2) of the F.A. 1923, become part of the taxable investment income of the life assurance policyholders' 'collective investment', and such policyholders may therefore reasonably complain of the unequal treatment of profits and losses arising from annuity business. Separation of the business would probably render necessary some provisions designed to preserve the alleviation of tax under Section 9 (3) of the F. (No. 2) A. 1940, but, even if satisfactory arrangements were made in that respect, would probably be inadvisable as long as N.D.C. and E.P.T. remain in force.

The next need applicable to all three classes is a clear understanding that offices are to be permitted to debit, in profit computations, a reasonable present value of contractual liabilities and of future expenses of the appropriate fund. Two points may usefully be remembered, viz. (i) the long-term nature of the business makes financial conservation necessary and the Revenue is benefiting now from conservatism of the past, (ii) the Board of Trade is interested in the fulfilment of obligations by the offices.

Lastly, business taxed on a profit basis needs some allowance for actual but unrealized depreciation in the value of investments. The precise nature of the allowance requires careful thought in conjunction with any other concurrent amendments. It is possible that the present law applicable to life annuity business may be found to be satisfactory if applied to the other two classes of business also.

I acknowledge with gratitude numerous helpful criticisms from Mr J. H. Kitton, F.I.A., and a most useful elucidation of what was a puzzling point from Mr A. Simon, O.B.E., F.C.A., Secretary of the Association of Investment Trusts.

ABSTRACT OF THE DISCUSSION

Mr A. H. Shrewsbury, in introducing his paper, said that he felt that he ought to apologize for its length; there had been no lack of effort to be brief, but the difficulty had been to present a coherent account without grossly exceeding the customary space. In order to do so, it had been necessary to place strict limits on the scope of the paper. Even within those limits, the account given was not complete, and he hoped that it would be borne in mind that he had had to select what seemed to him to be the more important points.

He could imagine that disappointment would have been caused by the omission of a convincing argument establishing in principle that the present burden of income tax on life assurance funds should be reduced. His inability to discover such an argument was the main factor which he had had in mind in allotting space to various aspects of the subject. Twenty-five years ago, much argument had been directed against the taxation of life assurance funds by any method based upon investment income. The paper was founded on the view that that battle was a lost battle. Also, he had implicitly accepted the Revenue view that, in present circumstances it was not possible to establish, in principle, that life assurance funds were entitled to a differential rate of tax at some rate less than the standard rate. It followed that it was largely a matter of expediency whether any particular variation of the numerous possible methods by which taxation could be based upon investment income was adopted, and there were few comments of enduring value which could be made when the essence of the matter was not principle but expediency. Therefore, although he fully appreciated that in such a vexed subject nearly every argument had its counter-argument, he had decided not to allot space to what seemed to him to be the impracticable aim of rebutting the Revenue attitude to the taxation of investment income.

If, however, they acquiesced in the Revenue attitude to the taxation of investment income and, in effect, in spite of the points which could be urged against it, accepted the Revenue hypothesis that a life assurance fund was a collective investment of the policyholders, it followed that life assurance thereby became taxable not only in a manner peculiar to itself but also on an exceptionally onerous basis. They were therefore fully entitled to demand clear and consistent taxation rules applicable to that specialized basis. What, however, was actually found? First, notwithstanding the conception that a life assurance fund was a collective investment of the policyholders, and therefore taxable on investment income, there was no clear-cut distinction between the interests of policyholders and of shareholders. The life assurance fund, which was predominantly an interest of the policyholders, who were not trading, remained subject to taxation rules which were applicable to traders. Secondly, the interests of shareholders, who were trading, but were trading in a very specialized manner, were subject to rules which were designed primarily for ordinary short-term commercial transactions, those rules being sometimes not clear and sometimes positively inappropriate.

Naturally it was possible to extract from the tangle of conflicting principles some apparently logical argument relating to any point which might be in dispute; the waste of time so caused was great. That was a disadvantage both to the Revenue and to the offices. What was more serious was the lack of a clear and consistent basis, thus affording the Revenue the opportunity on one occasion to make use of one premise, and on another occasion of another, and, in the aggregate, to obtain the benefit of mutually inconsistent arguments.

The proposed amendments in the last part of the paper were stated very briefly, because there seemed to be little advantage in considering minor points until major ones were agreed. The proposals represented an attempt to remove inconsistent alternatives in the application of taxation. With regard to pre-1938 sinking fund business, permanent sickness business and annuity business, it seemed almost inevitable that the offices would remain confronted with Case I, and it was there that the greatest difficulty was encountered in finding a reasonable basis. It was reasonable to expect a greater measure of agreement with the view that the law was unsatisfactory than with the remedies which he had suggested, but he hoped it would not be forgotten that it was the Revenue which benefited from inconsistencies.

Mr R. J. W. Crabbe, in opening the discussion, said that in recent years, new statutory provisions had necessitated a much greater precision in determining the taxable profits of the proprietors of a life assurance business, and, as a result, many points which before were not of great practical importance had been the subject of discussion with and decision by the Revenue authorities. It seemed to him that it was vital to the understanding of the present income-tax law to appreciate how it had grown from certain earlier, rather fumbling attempts to apply certain principles which were supposedly of universal application to a vast diversity of different businesses. If, as he was afraid might be the case, at any rate, with some of the younger generation, there were a tendency to look no further back than the I.T.A. 1918, some practices in income-tax law might be difficult to understand, unless it was realized that the application of the law had been in course of development over a period of more than half a century. In such a case there would be a tendency to focus attention on the special problems of income tax as affecting life assurance business without that appreciation of general principles which would be of the greatest value in understanding the Revenue approach to the matter.

As the author had so clearly shown, the principal difficulties seemed to arise from the conflict between the view taken by the Revenue, which treated interest earnings as a separate subject of charge to tax, which could not be considered in computing the normal Case I Schedule D computation of trading profits, and the view taken by the life offices, which treated interest as a subject of trade. Under present methods it seemed quite impossible to reconcile those differing views, and in those circumstances, attempts to compute the proprietors' profit on a Case I Schedule D basis had led to obscurity and confusion.

He thought, then, that there would be general agreement with the suggestion that a complete overhaul of the matter from that aspect was necessary. Difficulties which in the past were of relatively minor importance had of recent years become vital, as a result of new taxes and new rebates which had been introduced in the last five years, such as N.D.C., E.P.T., and the relief under section 9 of the F. (No. 2) A. 1940.

The alterations which were suggested in paragraph 24 of the paper would remove the anomalies which were inherent in the present system, but they did involve the jettison of any attempt to apply to life assurance the general taxation principles which were applied as far as possible to all other businesses. He felt a certain hesitancy in asking for any solution which treated life assurance as something of a special nature, something quite different from all other businesses. It seemed to him that the Revenue was fundamentally right when it adopted the attitude embodied in the quotation at the head of the paper, namely, that 'all traders, whether in groceries, annuities or other articles of commerce' should be assessed 'upon the same footing'.

He had tried to discover an approach to the matter which would give an answer to the problem in harmony with the Revenue contention; and it seemed to him that it might be found in an enlargement of the conception of the fund as a collective investment of a number of individuals. He agreed that the policyholders were not trading, but it was necessary to accept something a little out of the ordinary in the present situation, and it seemed to him that no harm would be done if the principles of taxation as applied to a trading company were extended to the whole operation of a life assurance company, on the ground that it was engaged in collective investment.

He suggested, therefore, that the life assurance fund should be taxed as a whole, no attempt being made to separate the interests of the several partners in what was a collective investment. In that event the difficulty of the Revenue in accepting the principles of the actuarial valuation, mentioned in paragraph 20 of the paper, would disappear, for it would then be possible to compute an annual realized Case I profit or loss which would be based entirely on figures in the revenue account. Such items of actuarial profit as mortality profit, profit from surrenders and so on would not then be involved, for they did not in any way affect the aggregate return to the group as a whole. The computation would normally produce a Case I loss which was composed principally of the allowable expenses, and into that computation it would also be necessary to bring any other items which were normally included under the normal Case I rules. Tax on that loss would then be recovered in the normal way, i.e. under section 34 of the I.T.A. 1918, by reference to the tax suffered on the interest income.

It was quite clear that the practical effect of such a conception would not be very different either from the present basis of interest less expenses or from the suggestions made by the author. He thought, however, that there would be important consequences resulting from the difference in the argument by which the basis was reached. First of all, the whole of the computation would be based on the same rules as were applicable to other businesses. Secondly, if, because it exceeded the amount of the interest income, some part of the Case I loss to which he had referred could not be recovered in one year, the whole could be carried forward in the ordinary way and set off against subsequent interest income. The third and perhaps most important point was that the calculation of the proprietors' profit would be based on a completely different conception. If it be accepted the conception that the Case I rules could be applied both to the proprietors' and to the policyholders' profits would remove any difficulties which might arise from the Revenue feeling that any disallowed items which were not added back in the proprietors' computation thereby escaped taxation. It would be obvious that if they were not added back in the proprietors' computation they would be included in the computation of income upon which the policyholders were taxed, and therefore they would suffer taxation on the terms upon which the policyholders' section was liable.

There would remain the relatively simple problem of determining in what proportions the proprietors and policyholders respectively were entitled to take the profits, remembering that the total amount of those profits on a normal Revenue basis had already been settled. That division between the two parties was, of course, determined by the terms of the contract between them, and for income-tax purposes the division would presumably follow the same principles. Therefore the natural method would be, as the author suggested, to have regard to the actual amount of profit taken by the proprietors out of the business. The only serious difficulty which he could envisage arising, so far as the Revenue was concerned, was that it might claim the right to base the proprietors' profit on the amount which they could have taken, rather than on the amount which they actually did take, as a safeguard against any tendency to retain large amounts of profit in the fund during periods of high taxation. It seemed to him, however, that such a tendency could be disregarded, for it could be exercised only at the expense of current distributions to proprietors, and in most cases to policyholders also, and would not materialize except on the most urgent business considerations. There was therefore, as a basis for the proprietors' profit, the actual amount taken by them out of the business.

In addition, there arose the problem of any items which had been disallowed in making the main computation. He thought that the correct course with such items would be to say: 'If these items which have been disallowed had not been expended, how much more would the proprietors have been entitled to?' and to add that amount to the proprietors' profit.

He thought that it became quite clear, by arguing on those principles, that it would be wrong in many cases to add back the whole of such disallowed items to the proprietors' profit, a course which was insisted upon by the Revenue in certain cases under the present method.

It was also necessary to deal with the problem which arose if the proprietors took more than the total profit arising on the combined transactions. It seemed to him that in such a case it would be right that they should pay tax on what they actually took; but if that was only a temporary phenomenon, and in later years they took less than the total combined profit, they should be allowed as a credit the excess which had been taxed in the earlier year.

He could not on that occasion deal in detail with the application of that suggestion to the annuity profits, but observed that the special method of taxation of an annuity fund (which arose as a result of the fact that the annuitants were taxed on the whole amount of their annuities, and not on that part only which represented interest) would fit more logically into the conception which he was putting forward than it did into the present method of taxation.

Considerable prominence was attached to one of the other aspects of life office taxation, viz. the relation between the individual liability of the policyholder and the actual tax which he ultimately suffered when the numerous tax liabilities and rebates which affected such contracts were brought into account. It seemed to him that a solution of that problem on the lines of a lower rate of tax applied to the whole of the interest income of the life assurance company would not really meet the difficulty caused by the fact that certain policyholders were not liable to tax on their own account, while other policyholders were liable both to income tax at the full rate and, indeed, to surtax. Unless offices were to be faced with a hopelessly complicated method of determining how much tax had been suffered in respect of each policy—a method which would be absolutely impossible of application in practice—he did not see any alternative to the present method of taxing the company on the assumption that in the normal way all policyholders were liable to the full rate of tax, and of allowing a modified rebate upon premiums, in order to relieve the hardship to certain of the policyholders and to encourage thrift.

He had not time to deal in any more detail with that aspect of life office taxation or with some other aspects; therefore he would close with the suggestion that under the present system, accepting the Revenue principle of collective investment, the tax liability was in the majority of cases, he would not say quite fair, but on a reasonably fair basis, and that any modifications which were necessary in order to remove individual anomalies would have only a small effect on the aggregate tax liability of the majority of companies.

Mr C. F. Wood remarked that he wished to develop Mr Crabbe's point of the relationship between the office and the individual policyholder. It seemed to him that most of the difficulties of high rates of income tax arose not from the bases of the taxation of the life offices but from the nature of the contracts which offices made with their policyholders. There was inherent in those contracts a transformation from income to capital. The offices received the premiums and invested them at a gross rate of interest; the policyholders were allowed a guaranteed net rate of interest in the form of payments of capital. In all other forms of financial transaction the interest was paid as interest, and the person making the payment could deduct income tax at the rate current; the recipient was therefore responsible for any increase in income tax which might take place. If the contract stipulated the payment of a fixed net rate of interest, the Finance Act of 1941 made the recipient responsible for the increase in taxation.

Under the policies which offices had issued they made themselves responsible for the whole of the increased income tax; in other words, they guaranteed the rate of interest to the policyholders and they gave, in effect, guarantees against future increases in income tax, thereby making the offices dependent on the rate of income tax for their solvency. Policies in that form favoured the surtax payer; not only did they relieve him from surtax on the interest which he was allowed, but they enabled him to avoid aggregating what was really interest with the rest of his income. He thought that many of their so-called problems of tax evasion arose solely from the form of contract which the offices had issued: a contract which paid out net interest as capital.

In the case of educational endowments and instalment policies, the offices went a step further; not only did they turn net interest into capital during the premium-paying period, but they allowed the capital to accumulate at interest during the instalment period and then paid that interest as capital. That was not 'interest on interest' but, if he might use the expression, 'capital on capital'.

He did not think that the tax problem would be solved until a new form of life assurance contract was devised, under which the true interest was paid as interest, and paid in the form of gross interest from which income tax could be deducted. What form that policy or contract should take he was not prepared to say without a great deal more thought. It would be necessary to decide whether the interest was to be reckoned on the gross premiums, on the net premiums or on the premiums less some allowance for risk. There would be the very difficult problem of deciding whether the interest accrued from year to year or whether the recipient received the whole of the interest as income in the year in which the sum assured was paid.

The idea which he had in mind could be illustrated by a simple example of a sinking fund policy. He asked whether it would not be possible to issue a sinking fund policy under which the sum assured was stated to be the accumulation of the premiums paid at a fixed rate of interest of $x\%$ per annum gross, subject to income tax at the rate current from year to year. That form of contract might be developed into a policy to replace the present type of endowment assurance, under which the sum payable at death was £1000, and the sum payable at maturity was some part of the premiums, to be determined for each policy, accumulated at $x\%$ per annum, less income tax.

Before the exact form of contract in a practical form could be devised it would require very careful consideration, but there were certain steps which could be taken now to avoid what he had described a little earlier as 'capital on capital'. All new policies of the educational endowment type, the family protection type, and instalment policies generally, should be issued in such a way that the sum assured was an annuity certain, and then the offices could deduct tax at least from that interest which accrued after the instalments commenced.

Mr J. G. Hill (a visitor) said that his views were very largely in agreement with those of the author, but there were one or two points upon which he would like to comment.

The first concerned paragraph 6 of the paper, where the case of Clerical Medical and General Life Assurance Society *v.* Carter was quoted. Another case on the same point was that of Revell *v.* Edinburgh Life which was decided in 1906. The decision was really on all fours with that in the Carter case, and he mentioned it only because of some words of the Lord President which had a bearing on another aspect of the paper, namely, that of taxing both interest and profits, which was dealt with in paragraph 17. The Lord President made the following remarks:

> 'I thought it had been settled beyond all possibility of doubt, that inasmuch as the Income Tax Acts do not only deal with profit in the true sense of the word as a commercial profit, but also deal with and impose taxes upon the interest of investments, the Crown has always been allowed, when investments are held by a trading company, if it suits them, to say: "We will charge you a tax upon the produce of your investments, and we won't charge the tax upon your profits." The Crown cannot charge the tax on both—that is to say, it cannot take a trading company which has money—its assets and investments—and first of all charge income tax upon the produce of investments and then over and above charge on the profits. It must elect between the two.'

His next point concerned paragraph 7 of the paper, where in subsection (i) it was stated that if there was a profit according to the rules of Case I, such Case I profit should be taxed and the investment income should also be taxed, so that the total tax payable was equal to tax on the earned actuarial surplus. On the next page an example was given to show when such a situation could arise. He had never come across such an instance in practice, but he was rather new to the life assurance world, so that perhaps he was not likely to have done so; but, if such a situation should arise he would endeavour to make use of section 33 of the F.A. 1926 (under which losses could be carried forward for six years), in order to try to take advantage of previous losses arrived at on a true Case I basis. He knew that he would be faced with the answer that section 33 did not apply, but he would try to make it apply, because section 33 did not specifically refer to Rule 15 so as to exclude life business from its effect, in the same way that section 13 of the F.A. 1937 did, where it excluded any effect on the original rule, and Rule 15 could not possibly mention the carrying forward of losses, because the carrying forward of losses did not exist when that section was passed.

In conclusion, he was particularly interested in the comments on page 54 in connexion with sums written off life investments in excess of actual depreciation. Bearing in mind section 16(1) of the Act of 1923, he could not understand how the Revenue could suggest that items set up as investment reserves were not amounts set aside for the benefit of policyholders.

Mr G. H. Recknell said that paragraph 11 of the paper brought out very clearly the point that in the interpretation of section 33 of the I.T.A. 1918, the Inland Revenue adopted a conception of profits which did not correspond with the Case I computation, and which had therefore no clear statutory basis. While that practice of the Revenue had certainly made the Act workable, it had none the less introduced an intolerable confusion between Case I artificial profits on the one hand and actuarial surplus on the other. That was, however, by no means the only instance of a procedure which was not supported by any statutory basis. For instance, particular items of expense in connexion with the expenses claim under section 33 of the I.T.A. 1918 were allowed or disallowed by the Revenue according to whether or not they accorded with the Rules applicable to Case I; none the less, expenses claims of that kind were not submitted in connexion with Case I claims, and it seemed doubtful, therefore, whether in that instance also the Inland Revenue was supported by any statutory authority for its practice.

In paragraph 12 of the paper, the author drew attention to section 237 of the I.T.A. 1918, which defined life assurance business as including annuity business for purposes of taxation. Recognizing, therefore, in the face of that definition, the impossibility of taxing annuity profits directly, the Revenue appeared to achieve that purpose under section 16 of the F.A. 1923, by taxing annuity profits indirectly, by providing that such profits operate as a limitation on the expenses of management claim. It seemed impossible to reconcile the provisions of section 237 of the I.T.A. 1918 with even that indirect assessment of annuity profits. There seemed to be a good case, therefore, for abolishing section 237 of the 1918 Act and section 16(2) of the F.A. 1923, and for the introduction of new legislation providing for a direct assessment of annuity profits. If, in addition, the Rules of Case I for computing profits were altered to require the inclusion of investment income, and the liability in respect of both profits and losses were determined in the years in which they arose, most of the anomalies of the present situation would be removed.

There was a further point concerning annuity taxation to which the author had not referred. The right of offices to retain and withhold tax on annuity payments up to the amount of the interest income provided a direct inducement to such offices to build up interest income to an amount at least equal to the amount of annuity payments. In the absence of deferred annuity business, it would normally be the case that annuity payments exceeded interest income, but the transaction of deferred annuity business did operate to build up the interest income on the one hand without immediate increase in the annuity payments on the other hand; so that it was the case that for many offices the transaction of deferred annuity business helped to build up an ideal equilibrium between interest income from annuities and annuity payments.

Reference was made in paragraph 13 of the paper to the situation which sometimes now arose in connexion with post-1937 sinking fund business. Such business might show a loss on a Case I computation, even after including interest income. It was hard to see why, with the law as it now stood, any difficulties should be placed by the Revenue in the way of allowing such offices to establish a claim for relief on that loss under the terms of section 34 of the I.T.A. 1918. Such a situation had in fact arisen in his own office, and they had never yet succeeded in obtaining a satisfactory reply to their request for relief.

Dealing with more general questions, he hoped that the advocates of the profits basis of taxation would be finally silenced by the author's arguments. Investment income was *prima facie* the proper basis for taxation, and the arguments for that basis were set out at length in the evidence before the Royal Commission in 1920. It was argued by the Revenue that life offices in essence transacted the business of investment not different from that of other financial and investment companies. They collected premiums, they invested them, and ultimately they returned the accumulated proceeds, in the form of sum assured and bonuses, to their policyholders. The fact that the dates at which those returns were made were uncertain in point of time made no difference to the fundamental position, and therefore, their business being the transaction of investment, the proceeds of those investments, namely interest, were the proper subject for taxation. The Scottish offices in their evidence supported those arguments, but the English offices put forward a profits basis; and thus, not for the first time and perhaps not for the last, the Scottish offices were right and the English offices were wrong.

Mr A. Simon (a visitor) said that one point which struck him in reading the author's very interesting paper was the contrast in treatment of insurance companies and other businesses included within the ambit of section 33 of the I.T.A. 1918, which dealt with management expenses. He had some knowledge of what took place in the case of the investment trust companies, and their charter was the Grange Trust case, fought some ten years ago.

That was a most important case for an investment trust company, because in a time of slump it meant that they continued to get their tax on their management expenses, whereas if proviso (*a*), which called for a notional Case I assessment, applied, they might be in the position of getting nothing at all. If their income was £50,000 and expenses £10,000, they would get back tax on £10,000 in time of slump. They might have had an income of £60,000 the year before, with expenses £10,000, and then the operation of proviso (*a*) would mean that they would get nothing for management expenses, so that the Grange Trust decision was a very important one. Although section 33 of the F.A. 1933 did say that they could carry on for six years any expenses which had been disallowed, in the same way that an ordinary trading company could carry a loss on for six years, yet in a time of slump it might well be that the six years would be exhausted before they could recover, and also in such times a bird in the hand was more than ever worth two or three in the bush.

He had been caused to wonder, after reading the paper, how far the Grange Trust case could apply to a wholly mutual life office. Presumably section 16 of the F.A. 1923 made statutory provision for a mutual office not being assessable under the rules applicable to Case I. It would therefore seem to be on all fours with an investment trust company; in other words, it was a business which could not be assessed under the rules applicable to Case I, Schedule D. If that was so—but probably there was a fallacy in it—the Grange Trust case would apply. Normally it might not be of much importance to an insurance company, because, even in times of slump, in a mutual office, where the taxable income consisted wholly of investment income, all profits being eliminated, the excess of new business over claims would involve such greater investment as not to make the investment income in year II less than in year I, particularly if the office had a fortunate year so far as claims were concerned. Having regard however to the nature of life fund investments, which he presumed consisted mostly of dated securities of a very highly respectable nature, and with interest rates, as was now the case, tending to be reduced, presumably a position might arise in present conditions of war, when fighting became intense and casualties were great, in which claims increased, and in which the investment income of a mutual office in year II might be less than its investment income in year I. If such a case was a practical possibility, the Grange Trust case would be of great importance to a mutual office.

Mr H. E. Raynes recalled the saying of a judicial historian that it was better to have the law certain than to have the law just. In the case of income-tax law, so far as it related to life assurance, he thought that it was both partly unknown and also unjust. So far as they did know it, they had had to modify their business to accord with the Act and to adopt principles such as increasing their deferred annuities when their immediate annuity business was in excess, and *vice versa*, so as to get the optimum position. There could be no doubt that it was their duty to do the best they could for those whom they represented, both policyholders and shareholders.

The most intolerable difficulty, as was shown in the paper—and speaker after speaker had referred to it—was the computation on Case I rules; and the notional Case I rules had gained in importance for life offices in consequence of N.D.C. and the F. (No. 2) A. 1940. He thought that the author's suggestions for improvements towards the end of the paper were the right ones to pursue to remedy the situation, and that life assurance (apart from annuities) and post-1937 sinking fund business should be taxed on interest less expenses. The author agreed with the views of the Scottish offices, which were opposed to the opinion expressed by Mr Marks as a member of the Royal Commission in a separate proviso.

It was of great importance, he thought, that the Inland Revenue should get the same conception of the life assurance fund as that which lay behind the Act of 1909. The provisions of the 1909 Act were very definite. Section 3, for instance, provided:

> 'A fund of any particular class shall be as absolutely the security of the policyholders of that class as though it belonged to a company carrying on no other business than assurance business of that class, and shall not be applied directly or indirectly for any purposes other than those of the class of business for which the fund is applicable.'

In the balance sheet there was a declaration by the directors and auditors that 'No part of any fund had been applied directly or indirectly to any purposes other than those of the class of business to which it is applicable'. There was definitely the notion that the life assurance fund was a fund for the policyholders, and unless and until some portion was transferred to other accounts the whole enured for the life policyholders, as if the company were a mutual one and the policyholders had the whole interest in that fund. That was the view which they wished to take and to emphasize, and they wanted to get the authorities of the Inland Revenue to adopt the same point of view. If they could achieve that object many of the present difficulties would be avoided.

The further suggestion which the author made—and it was an obvious one—was that N.D.C. was totally inapplicable to life assurance business—a temporary tax, dealing with permanent contracts. What was obtained by the Revenue from N.D.C. from the point of view of life assurance was comparatively insignificant; and endless correspondence had passed between offices and their tax inspectors on the importation of Case I into the computation of the rebate of 2*s.* 6*d.* provided by the F. (No. 2) A. 1940. If those anomalies could be removed, the tax situation of the offices would be much simpler, and the Inland Revenue would be saved a great deal of trouble.

Mr C. H. Ashley said he wished to add one more difficulty to the many which were pointed out in the paper. At the end of paragraph 20 of the paper, the author, speaking of section 16(1) of the F.A. 1923 said:

> 'The method now used is to regard the taxable surplus expressed as an amount per annum, before income tax is added back, as analogous to an annual salary free of tax, to add back tax accordingly, and to regard all tax paid or suffered, except such amounts added back, as appertaining to policyholders.'

He had been informed that an instruction had been issued from the office of the Chief Inspector of Taxes that if an office chose to put a certain amount of income tax in its revenue account, under the heading 'Income tax thereon', then whatever it chose to put there in the case of a branch like the industrial branch of an office it must abide by as being the tax to be wholly added back to the shareholders' profits,* upon which no one disputed that tax should be paid under Case I, Schedule D. Therefore, if an office apportioned its interest and its tax between (to take a simple case) an ordinary branch and an industrial branch, in proportion, say, to its funds, then it was getting a much greater sum of tax shown in that industrial branch account than it would otherwise have there if that tax were confined solely to the amount actually suffered. That made a very great difference to the net yield which the funds in the industrial branch would show compared with the ordinary branch. Moreover, it seemed to him quite impossible to put into the industrial branch account the net tax suffered for the relative year under Case I, Schedule D, basis with its various adjustments, because in his experience it took about twelve months to arrive at a settlement with the income-tax authorities.

He was not aware how the income tax in the two accounts of every office which transacted both industrial and ordinary business was shown in their accounts, but it seemed to him to be a point which could be of very serious importance, and if the instructions issued by the Inland Revenue were not withdrawn, it meant that another problem was added to the many which already had to be dealt with in regard to income tax.

Mr S. B. Dunphy said that in the paper complaint was made that taxation was very onerous on an old, well-managed office, and that a new office, such as an industrial office, and more particularly a Dominion office, escaped such a high rate of tax. For his present purpose, he would call the expenses of that old, well-managed office the normal expenses. The normal expenses were higher in the early years of a policy and the interest was lower, and therefore the proportion which the expenses allowance bore to the interest was higher in the case of a young fund than in the case of an old fund. In addition, of course, to what he called the normal expenses there might be other expenses for purposes of expansion, and there might possibly be some complaint if those expenses, as they did, attracted an income-tax allowance.

* [Mr Ashley reports that the instruction in question has since been withdrawn, and that the amount to be added back is that part of the tax suffered on behalf of the shareholders. Eds. *J.I.A.*]

A company which had its head office abroad, and which decided to transact business in the United Kingdom, did not get an expense allowance based on the actual expenses so incurred, and, of course, did not pay tax on the interest applicable solely to that business; it paid tax on a proportion of its total interest less expenses, the same proportion being applicable to the interest as to the expenses. But as the ratio of actual expenses to actual interest income would be higher for such business than for the company as a whole, the company did not obtain the full expense allowance to which it was really entitled. That was a disadvantage which should be set off against any advantage obtained in respect of any allowance for expenses applied to its general expansion.

Mr A. W. Joseph, referring to Mr Simon's remarks on the application of the Grange Trust decision to a mutual life assurance office, said that in fact a mutual office did not have any difficulty with regard to its Case I computation, because that was covered by the provisions of section 16(1) of the F.A. 1923. All the Case I profit was held to be made on behalf of policyholders, and no tax was payable. With regard to paragraph 11 of the paper he doubted whether, whatever the scope of the Grange Trust decision, proviso (*a*) to section 33 of the I.T.A. 1918 could be read to mean that the relief given by the section should not make the tax paid by the company less than nothing. The text of the proviso was 'relief shall not be given under this Section so as to make the tax paid less than the tax which would have been paid if the profits had been charged in accordance with the said rules'. It did not state that the tax paid must not be less than the Case I profit itself. The Inland Revenue would argue that even if the Case I profit were nil the tax which would have been paid if profits had been charged in accordance with the rules of Case I was the tax on investment income plus the Case I tax.

The author referred at the foot of page 55 to the minor but somewhat troublesome point regarding the treatment of expenditure of a capital nature. The Inland Revenue held that all investments were vested solely in the proprietors, who were, however, liable for certain contractual debts, the extent of which was measured by the actuarial liability. In practice, the Inland Revenue also allowed the carry forward to be treated as a reserve for policyholders, and the two together—the actuarial liability and the carry forward—made up the fund. Thus, any items of a capital nature which, being regarded as expenses of management, did not enter the fund, in that view belonged only to the proprietors.

The attitude of the Inland Revenue was, he thought, mainly conditioned by a fear that at any moment the office would go into liquidation, and contrasted with the office's own view that it would go on for ever. Any use which the capital items might have was considered by the Inland Revenue not to benefit policyholders but to provide the proprietors with facilities for the future carrying on of their trade.

In order to counter the Inland Revenue's contention that expenditure of a capital nature did not enter the fund, it had been argued—possibly quite wrongly, and certainly with no success—that the policyholders' fund was the assets in which the fund was invested, and that the balance-sheet figures merely served to show in what proportion the assets were divided among the respective creditors. From that aspect, it made no difference whether a particular capital item was shown explicitly in the balance sheet or not; the funds automatically received their share of all the assets.

Certainly the present practice bore hardly on those offices which, far from expanding or improving their branches, adopted a policy of reduction or consolidation, and yet incurred expenditure of a capital nature on account of the changes made. If the office stood on a 'replacement' basis in regard to management expenses, some expenditure of that nature would almost certainly be disallowed, because it could not properly be held to come under Rule 7 of Cases I and II and the remedy would seem to be to change to a 'depreciation' basis as soon as possible. In the case which he had mentioned of an office consolidating its branches, the normal depreciation allowance would probably exceed new capital expenditure, and income-tax relief would be obtained automatically, without the necessity for bringing in section 16 of the F.A. 1923. Most accountants would agree that a 'depreciation' basis was preferable to a 'replacement' basis.

Mr S. J. Rowland said that in dealing with the question of profits or losses from realization, referred to at the foot of page 53, the author suggested that in some cases realized profits on sales of securities were excluded from the profit computation of the annuity fund. That view appeared to be contrary to the one expressed in the paper for which he had been jointly responsible with Mr Wales and to which the author had referred, where it was stated that in the ordinary way those profits were brought in. It was very difficult to understand the principle by which such profits were excluded. It seemed to him that if that one item were properly excluded others might be excluded or modified also. Either it was necessary to adopt the principle that the annuities were merely a liability of the general body of policyholders, and that the annuitants had no share in the assets of the general body of policyholders—in other words, that the annuity contracts were merely guaranteed, and not secured on specific assets—in which case it was quite understandable that those profits should be excluded, or, as must surely be the case, the position was that the annuitants were jointly interested with the policyholders, and they each had their rateable share of each particular asset, and therefore the profit or loss on the sale of any asset must come into the computation of profits.

He was interested to hear from Mr Recknell that there were still offices who were seeking deferred annuity business to balance their immediate annuities. It would appear that by give and take between a few offices it would be possible to deal with the position to their general benefit.

Mr A. S. Holness said that he believed that it was a political principle enunciated many years ago that the power to tax was the power to destroy, and that was nowhere so patent as in the case of life assurance. In transacting life assurance business an office necessarily made long-term contracts under which it undertook to pay a fixed capital sum in consideration of annual payments; and the experience of the last two hundred years showed that the policyholder had received on the average something more than he had paid, by virtue of the interest earned on assurance funds. But, whatever rate of interest might have been assumed in the past, the rate of income tax could reach a point at which life assurance funds would be rendered insolvent. What had in fact been done was to make the tax not the normal rate of tax for other forms of income but the apparently purely arbitrary rate of 7*s*. 6*d*. in the £, although it might be that in the opinion of the authorities that rate was almost the limit of taxation for life assurance funds if they were to remain solvent.

Since the taxation of life assurance funds was a subject in which there was no guiding principle, but simply patchwork, might it not be possible to replace that situation by devising some fair basis of taxation, which would automatically ensure that, whatever the rate of tax might be, it would be possible for life assurance funds to meet their contracts? He did not often find himself in agreement with the principles upon which United States' tax legislation was based, but possibly a suggestion might be found there which would have some appeal. He believed that in general the principle there was that the valuation rate, or an over-all rate roughly corresponding to an average valuation rate, was allowed free of tax to all life assurance funds first of all as a base-line, and the interest above that, and only the interest above that, was subject to taxation. It seemed to him that possibly some such arrangement as that could be adopted in the United Kingdom. A very rough calculation, based on the Board of Trade returns for 1937, showed that such a change would not at the moment make an enormous difference to the total tax payable to the Revenue under present conditions, and might operate with reasonable fairness. It would abolish the anomaly that an insurance office whose interest earnings were small and whose expenses were high would be taxed on a low basis, and *vice versa*, quite irrespective of their relative profit earnings.

From the practical point of view, the figures which he had deduced might be of some interest. For ordinary life business of companies, with their head offices located in the United Kingdom, there was a mean fund, in 1937 of, say, £960,000,000. Gross interest might be estimated from the net published figure as approximately £52,000,000, and commission and expenses as £13,000,000, leaving a taxable basis of £39,000,000, which, with tax at 7*s*. 6*d*. in the £, would give a figure of £14,600,000. If, instead of that, the first 3 % on that fund, £28,800,000, were free from tax, and the balance, £23,200,000, subjected to the full rate of 10*s*. in the £, the tax would be £11,600,000. That would result in a small reduction in the total tax payable by the insurance companies as a whole, but not to such a degree that it could not be contemplated by the Government; and it seemed to him to represent a logical basis which would be workable, and would not involve the life assurance contracts of the country in jeopardy by changes in the rate of tax.

If an objection were raised that such a change would treat the savings of life assurance on a basis totally different from other forms of saving, the answer was that life assurance was already treated in exceptional ways in more than one provision of the Acts; and further, if it were thought advisable, the old business, in force previous to such a change, could be treated like sinking fund business, separately from the new business, where the new contracts would be made in the full light of the facts.

Mr R. J. Kirton, in closing the discussion, referred to Mr Holness's use of the word 'patchwork', and to the fact that in his opening remarks the author spoke of 'a tangle', while in the paper a very illuminating quotation was given from the Income Tax Codification Committee's Report of 1936, in which occurred the words 'adding a patch here and there'. Was not that curse of patchwork, he asked, really the key to the whole illogical structure? The subject was a web of rules and sections, and through that web it was very difficult to follow the thread of common sense; in fact, it often seemed that the thread had disappeared altogether. The paper had helped him more than he could say to get some grasp of the whole subject, but, like Oliver Twist, he would like to ask for more.

In dealing with section 9(3) of the F. (No. 2) A. 1940, the author gave something of the background against which that legislation was carried through, and he would appreciate it greatly if, in his written reply to the discussion, the author would give something of the background against which some of the other important Acts were brought into force, e.g. section 16 of the Act of 1923. It would be most helpful to have a description of what the legislation was in fact meant to do, as distinct from what it had in fact done.

In a paragraph at the top of page 44, where the author dealt with the combined effects of section 33 of the Act of 1918 and section 16 of the Act of 1923, and with the annuity fund and the life assurance fund combined, there was a phrase in brackets, 'diminished by such life annuities and other annual payments as are paid out of taxed income'. He thought that the phrase should read: 'diminished by such life annuities as are paid out of the taxed income of the annuity fund and such other annual payments as are paid out of the taxed income of either fund'.

There were two observations which he wished to make on the section of the paper dealing with 'Case I. Adjustments.' The first concerned the question of a change of valuation basis. The paragraph dealing with that on page 53 concluded with the words: 'efforts to arrive at a statement of the principles upon which approval may be expected have failed.' He felt that the Revenue could not be expected to enunciate principles beyond those which he understood to apply at present, viz. that a valuation for tax purposes must be reasonable, and that the income-tax authorities could not be expected to pass for taxation purposes a valuation which from that point of view was so conservative that its sole result was to withhold certain profits from taxation in years when tax was high, and to disclose those profits in years when it was hoped that taxation would be lower.

His other observation in connexion with Case I adjustments concerned that section of the paper dealing with depreciation of investments, actual but unrealized, where the following statement was made:

> 'The Revenue has made the concession that if, in a sinking fund account, whether pre-1938 or post-1937, profit is created by the release of actuarial reserves and depreciation is written off by the application of such profit, then, to such extent, "actual" depreciation will be allowed....'

He felt some doubt concerning the degree of reliance to be placed on that concession, and would like to ask the author how firm he felt that decision to be, and whether any case had arisen where it had actually been used in practice.

The last individual point which he wished to make concerned the part of the paper which dealt with section 33 of the Act of 1918, dealing with the effect of the proviso, which led to the special notional Case I computation. He would like to ask whether that portion, on page 41, where the author was dealing with that proviso, could be summarized in the words: 'Where the Case I loss is less than the expenses, then this loss, and not the expenses, is set off against the taxed income.'

Many speakers had dealt with paragraph 24, which was the section of the paper which looked towards the future, and that was possibly the most interesting side of the subject. He agreed with one or two speakers that life assurance and post-1937 sinking fund business, which, as the author said, must be grouped together, should be considered as the aggregation of the investments of a large number of small investors. He thought that such a view led to the argument of taxing policyholders' interests and shareholders' profit, and to the exclusion of all profit or loss on investments and appreciation and depreciation. He agreed with Mr Raynes concerning the very important point, to which the author and one or two other speakers had referred, that the Inland Revenue authorities attached far too little weight to the declaration which offices put on their balance sheets to the effect that no part of the funds had been applied for any purpose other than the class of business to which it was applicable.

In concluding, he would like to give two examples of lack of logic. The first was that a mutual office, identical with a proprietary office except that the latter had £1 of shareholders' capital, was taxed on an entirely different basis. The other was that what were quite rightly referred to in the paper as 'adjustments' were possibly the most important part of the subject.

He would like to thank the author very sincerely for his paper, which would be of inestimable help to all concerned in the subject.

The President said he had watched the development of income-tax legislation as it affected life assurance for a longer time than many of those present that evening, and, while he agreed that there had been a great deal of patchwork, he felt also that progress had on the whole been logical. His memory went back to 1913, when, as the author remarked, taxation was low, and the whole system was full of anomalies; taxation of the life business of a composite office was on an entirely different basis from taxation of a purely life office. That did not mean that the life fund of a composite office got any relief; he thought that the relief went to the shareholders. Also, in those far-off days, foreign income, if kept abroad, was not taxed, and that helped offices which were carrying on foreign life assurance business a great deal, because they had to compete with the native offices overseas.

In 1914 there came a change, and for the first time all income, whether brought home or not, was taxed. The offices did not like that, and started discussions with the Revenue authorities. Almost immediately war broke out and it was evident that taxation was going to rise. The authorities were told, in the first place, that if they insisted on taxing the interest income from foreign business the offices would be compelled to sell their foreign businesses, because they could not possibly compete on those terms, and so the country would lose control of what were then quite large foreign funds, which might have been of great importance to the Government in the prosecution of the last war. It was also suggested that there were grounds for giving the life offices a differential rate of taxation, rather on the lines of the taxation applicable to building societies; and the point was also made—he was not quite sure how far it went forward—that income tax, if raised sufficiently high, might imperil the stability of the life offices.

All those representations seemed to have had some effect on the Government, because in 1915 there was some quite important legislation, afterwards embodied in the Act of 1918. In the first place, the foreign life assurance fund was virtually exempted from taxation, as was the case to-day, and secondly the relief on the expenses of management was given. Other interesting alterations were made at the same time. The first was that the life funds of composite offices were to be assessed as separate businesses on exactly the same lines as the life business of a purely life office, and the second was that income tax deducted from payments of annuities could be retained only in so far as it was covered by the tax suffered on the income from the annuity fund itself, and not from the annuity and life funds combined, as had previously been the case under the Edinburgh judgment.

In his own view, in spite of the suggestion that that was all patchwork, as of course it was, all those alterations were quite logical and in the right direction. That process of what he might call rationalization was continued after the Report of the Royal Commission in 1920, and in 1923 there were further amendments which were also of importance to life offices. In the first place, the profits on the annuity fund, which had previously borne no tax whatever—and it must be borne in mind that the interest on the annuity fund also bore no tax—were brought into taxation for the first time. They were not assessed, but were brought in by the back door of adjusting the expenses of management claim. At the same time, the offices carried a point for which they had been pressing, that the Case I assessment should not include sums reserved for policy-holders. During the ten years 1920–1930, there were a number of cases of Case I assessments actually arising on ordinary life assurance business.

He felt that up to that time they were getting on fairly well. The offices for some time after 1923 managed to settle their troubles amicably with the Revenue; both sides approached the problems which arose in a spirit of goodwill and common sense, and, if the arrangements were not always strictly in accord with the letter of the law, he thought that settlements were obtained which were in accordance with the spirit of the law, which was much more important.

But, as the author had pointed out, the conditions to-day were quite different. War legislation and war reliefs had made the Case I assessment very much more important than it ever was before. There were difficulties with changing bases of valuation, changing values of assets and so on, and those difficulties were very real; but, having listened to the discussion that evening and having read the paper with great interest, he agreed with the author that it was not very easy to see what the ideal solution was. He thought that they must accept some sort of basis of assessment of interest, and he found it very difficult to convince himself that the Revenue authorities would abandon altogether their concern with Case I problems. He was very hopeful that the discussion which had taken place would help the author in the negotiations which he would no doubt be carrying on with the Revenue in due course on behalf of all the offices. It was to be hoped that the spirit of common sense and goodwill would be maintained, and that a satisfactory solution would again be reached. If that did not prove to be the case, presumably the remedy would be to take some of the cases which arose to the courts; but even then it did not follow that they would be any better off. They might get a ruling which told them what the law was, but, if they felt that the effect of it was unjust, they would still want to make representations and try to get the position put right.

He had really risen, however, to invite the meeting to express its hearty gratitude to the author for the paper he had presented. It was a model of its kind, and would be a standard paper on the subject with which it dealt for many years to come.

Mr A. H. Shrewsbury, in reply, said he very much appreciated the vote of thanks which had been accorded to him for his paper, and the kind remarks which the President had made.

He has subsequently written as follows:

Mr Crabbe agrees with the suggestion in paragraph 24(*a*) of the paper that the amount taxable in respect of trading should be the actual sums which cease to be applicable for the purposes of the life assurance fund and he seeks a procedure which will arrive at that result with the minimum departure from the principles and rules applicable to all businesses. He proposes to repeal Rule 15(2) of Cases I and II, thus eliminating the basic difference between the treatment of life assurance and of other businesses, and then to modify the present Case I computation in its relation to life assurance business. The proposed modifications are not defined but it is stated that the normal result would be 'a Case I loss which was composed principally of the allowable expenses' and that it would be necessary also to bring in 'any other items which were normally included under the normal Case I rules'. Mr Crabbe's proposals appear to involve two difficulties, viz. (i) in order to arrive at his normal result the normal rules of Case I must be subjected to such modifications as are not reconcilable with the conception that Case I relates to trading profits and (ii) the need to bring in 'other items' indicates that problems relating to the value placed upon assets and to profits derived from assets remain unsolved. His very interesting attempt to frame a system for life assurance business based fundamentally upon the principles applicable to all businesses thus indicates the difficulty of doing so. If, as Mr Crabbe appears to agree, the 'collective investment' hypothesis is to be accepted, then Rule 15(2) becomes necessary and the treatment of life assurance becomes fundamentally different from that of other businesses.

Mr Wood's diagnosis will probably receive general assent, but his cure, viz. throwing on to the policyholder the liability for tax on investment income, is likely to be at least as troublesome as the disease. Any attempt to establish, as notional income of the policyholder from year to year, an amount of interest on some hypothetical quantity will encounter practical complications on account of policyholders whose address is unknown (e.g. paid-up policies and cases where premiums are extinguished by the application of bonuses), policyholders who are not personally liable to tax and policyholders who have involved their policies in trusts or other legal complexities. It will be necessary to decide whether or not to make some allowance for mortality risk when computing the policyholder's liability: if no allowance be made then instances of injustice to policyholders seem inevitable; on the other hand there will be practical difficulties in settling such allowances: an endowment assurance maturing at a very high age is little different from a whole life assurance, and no simple rule such as setting aside a given amount or proportion of premium each year will avoid grave anomalies. Moreover it is not to be supposed that the Revenue or policyholders generally will accept actuarial calculations or tabulations as part of the taxation system or that the offices would care to undertake the work involved.

It is to be expected that the Revenue would require a simple rule such as subjecting to taxation, on an occasion when the office pays a surrender value or sum assured, the excess of such sum over the aggregate of premiums paid. As Mr Wood himself suggests, it would then be necessary to avoid the injustice which would follow if the policyholder's income for that year were thereby increased (e.g. into the surtax range) by a sum which truly related to many past years. It would probably be necessary to make some rule-of-thumb exceptions in favour of claims by death, but problems would arise concerning the aged policyholder who might claim that he had incurred a 'loss'. If such a system were in force the question would arise whether it could logically and fairly be confined to assurance policies. A bond bought at a discount involves the same argument. In fact the whole question of the taxation of increments in value comes in sight together with the accompanying problems relating to losses. Theoretically, injustice to some policyholders is unavoidable in taxing the life assurance fund instead of the individual policyholders. Practical considerations strongly indicate that it is the fund which must be taxed.

With regard to section 33 of the 1918 Act, Mr Simon's remarks show (i) that, in the view of the Revenue, the computation of profits to be made for the purpose of the proviso to subsection (1) which it terms a notional Case I computation, is a computation including all investment income, and (ii) the preceding year basis of Case I could have awkward results for an investment trust company. In life assurance business such results are unlikely. The notional Case I computation necessarily includes the Case I loss mentioned in paragraph 5 of the paper and it is also subject to reduction by the effect of section 16 (1) of the F.A. 1923. The result is a quantity which is not closely dependent upon the amounts of investment income and expenses. In ordinary life assurance the amount of investment income less expenses is commonly the effective basis of liability more or less permanently: in a mutual office the notional Case I liability is always nil because of the effect of section 16 (1) of the 1923 Act. In industrial assurance, expenses amount to a large proportion of the investment income and the result of the notional Case I computation, while commonly being greater than investment income less expenses and therefore usually the effective basis of liability, is usually a small proportion of the investment income. Thus the fact that that computation is based upon figures of the preceding year introduces only a minor disturbance which is insignificant in comparison with the instance given by Mr Simon.

I agree with Mr Joseph that there is room for argument concerning the meaning of section 33. In particular the Revenue can argue that 'the tax which would have been paid if the profits had been charged in accordance with the said Rules' must take into account the tax suffered by deduction from investment income. That argument, if established, would defeat every claim for relief under the section. The possibility of arguing in various ways is a natural consequence of ambiguity in the law and I see no reason to modify paragraph 11 of the paper.

I had in mind the case of Revell *v.* Edinburgh Life (1906) (Court of Exchequer, Scotland) 5 T.C. 221 when stating in paragraph 9 of the paper that the Revenue practice there mentioned had 'some degree of judicial support'. The Lord President said with reference to claims under section 34 of the 1918 Act (then section 23 of the 1890 Act) that 'not unnaturally' the Revenue claimed that a loss must be shown 'as on an ordinary commercial balance sheet, i.e., bringing in all income'. Lord McLaren, however, doubted the logic of insisting on the one hand that investment income must be taxed as a separate thing and saying on the other hand that it must be brought into the profit and loss account. These reflections, as both judges expressly stated, had no connexion with the point which they had to decide, viz., whether a sum of £1123 interest not taxed at source was liable to tax. They held that it was. As Mr Hill has said, the essence of the case is the same as in Clerical Medical and General Life Assurance Society *v.* Carter. The remarks of the Lord President in the Revell case which have been quoted by Mr Hill appear to refer to the option possessed by the Revenue either to assess untaxed interest directly or to include it in the computation of profits under Case I. It may perhaps be helpful to bear in mind that in 1906 life assurance business formed one business for income-tax purposes with fire and other insurance business and therefore normally there was a Case I profit of the combined business to be taxed: when a company transacted life assurance business only there would be normally no Case I profit to be taxed and the inclusion of investment income not taxed at source in Case I rather than in Case III would have been disadvantageous to the Revenue. The language used by Lord McLaren is perhaps easier to follow. He said: 'The Inland Revenue, having the election either to charge interest on investments as a separate subject of assessment or to allow it to be brought into the accounts of the trading company from which profit or loss is to be ascertained, elected to tax this Company upon the basis that the interest of their investments was to be taxed in the first instance, with the result that when a profit and loss account was made up excluding these investments there was a resultant loss.' This wording is not limited to investment income which has not been taxed at source but any doubt arising from the omission of such limitation seems settled by the Salisbury House case. The argument of paragraph 17 of the paper therefore appears not to be disturbed by the Revell case.

Paragraph 7 of the paper is a statement of underlying principles but, in giving the particular example regarding a closed life assurance fund, to which Mr Hill has referred, I did not foresee his argument concerning section 33 of the F.A. 1926. The section provides that a trading loss computed according to the Rules of Case I in respect of which relief has not been given under section 34 of the 1918 Act or under Rule 13 of Case I or under any other provisions of the Income Tax Acts may be carried forward and set off against any profits assessed under Schedule D for the six following years. The suggestion is that, in life assurance, liability for tax on a profit computed according to the Rules of Case I omitting investment income, may be avoided by invoking the Case I losses of previous years and remembering that Rule 15 of Case I will have prevented the allowance of those losses under section 34 of the 1918 Act or under Rule 13 of Case I. Section 33 includes however the additional phrase 'or under any other provisions of the Income Tax Acts'. Mr Kirton's summarized statement concerning the proviso to section 33 (1) of the 1918 Act gives conveniently its practical effect and the Revenue would no doubt say that the whole Case I loss is in effect allowed under section 33 of the 1918 Act when the notional Case I computation is the effective measure of liability and that, when that is not so, part of the Case I loss is in effect allowed when relief is allowed for expenses of management. As regards the excess of the Case I loss over allowed expenses I can see no flaw in Mr Hill's argument which leads to the practical result that there is a liability in principle when there is Case I profit, but the extent of the liability will differ according to circumstances.

I agree with Mr Recknell that it is not easy to understand the legal basis of the Revenue's objection to allowing losses in post-1937 sinking fund business which have been computed on the basis of including investment income. Apparently the objection is directed not against the allowance of an admitted loss but against the nature or the basis of the actuarial valuation by which the loss is computed. As Mr Kirton has indicated it is not to be supposed that the Revenue is, or should be, bound to accept, for taxation purposes, any valuation which an actuary deems advisable; but the differences of opinion which arise from time to time between actuaries and the Revenue, concerning points which appear to actuaries to be of fundamental importance, indicate the desirability of arriving at a settlement of certain elementary matters. For example, no plain assent has been given by the Revenue to the contention that an actuary must be permitted for Case I purposes to place upon the contractual liabilities a present value which is reasonable for the purpose of fulfilling those liabilities.

The Revenue concession relating to the treatment of depreciation in the value of investments in sinking fund business, which is mentioned near the beginning of page 55 from which a quotation has been given in Mr Kirton's enquiry, represents the view of the Board of Inland Revenue in the year 1942, and I am not aware of any subsequent event which would suggest that that view has been modified.

Mr Ashley's remarks correctly indicate that a point of importance has been omitted from the final part of paragraph 20 of the paper. I should have added that the method of 'grossing up' there mentioned is intended for use when an account has actually been subjected to income tax on the basis of investment income less expenses. A claim for relief under section 9 of the F. (No. 2) A. 1940 in, say, year (x) is subject to diminution by the notional Case I computation of the year ($x-1$) which includes tax at the rate appropriate to year ($x-1$) on the notional Case I computation of the year ($x-2$) which is itself already similarly 'grossed up'. When the account is liable to income tax on the basis of investment income less expenses the process of grossing up the notional Case I computation is thus a purely hypothetical calculation. When however the notional Case I computation is the effective measure of liability to income tax two methods present themselves, viz. (i) to add back the tax actually debited in the printed accounts and (ii) to apply the principles above described. Method (i) is not necessarily equitable. It will give the same result as method (ii) only if an office, in making up its accounts for a given year, computes its tax debit by deducting from the amount of tax suffered the amount of relief which will be found to be due in respect of that year, such amount being calculated consistently with the principles of method (ii)—a process which may involve practical difficulties. It seems that what is required is a working arrangement fixing the liability of the office according to the principles of method (ii) and providing that the difference between the amount of income tax debited in the printed account of a given year and the amount of tax liability for that year as ultimately determined shall be corrected by an appropriate entry in a subsequent year. The Revenue claims as a matter of course to go behind printed accounts and cannot reasonably object if, in order to obtain accurate results, an office makes the same claim.

Mr Dunphy has shown that the rules applicable to the United Kingdom business of a Dominion office can result in liability to a greater amount of tax than would be payable if exactly the same business had been transacted by an office established in the United Kingdom. That is true but it does not affect my comment that it is difficult to justify the comparatively light liability of rapidly expanding funds. I should have made it clear that that comment upon a weakness of the 'interest less expenses' basis was based upon the actual tax now being paid which, even though it may be greater than if the business had been transacted by an office established in the United Kingdom, is, in some cases, small.

It seems that Mr Rowland must have misread the passage at the foot of page 53, which indicates that the text is there over-condensed. It would have been better if it had included a reference to paragraph 12 of the paper where comment is made on the distinctions between section 16 (1) and section 16 (2). It is section 16 (2) which applies to the computation of the profits of annuity business as such and, as is stated at the beginning of page 54, in that computation it is usual to bring in any profits or losses realized by the sale of investments. Another instance of over-condensation has been pointed out by Mr Kirton: his amendment of the paragraph at the top of page 44 is of course correct: in using the words 'are paid out of taxed income' I meant 'are legally regarded as having been paid out of profits and gains brought into charge after allowing for the effect of Rule 21 (3) of the General Rules'. Principles relating to such payments are mentioned towards the end of page 47.

The first part of the answer to Mr Kirton's enquiry concerning the background of section 16 (1) of the F.A. 1923 is given by the President's review of events preceding the 1915 legislation. The situation, as it was after that legislation, is described in paragraph 11 of the paper and the offices were united in their dislike of the fact that alternative bases of liability existed. They gave evidence accordingly before the Royal

Commission but, as Mr Recknell has said, they did not then agree which single basis should be adopted for the future. The recommendations of the Royal Commission, given in paragraph 521 of their Report, were

'(*a*) That life assurance companies should be chargeable as at present on the amount of interest received less expenses of management.

'(*b*) That the alternative method of charging on profits should remain, but that the chargeable profits should be deemed to be not as at present the total surplus revealed by actuarial valuation, but only that portion of the surplus which belongs to the proprietors or shareholders of the company.'

In paragraphs 514 and 515, reasons are given for the Commission's view that actuarial surplus contains elements which cannot fairly be regarded as taxable profit and, in discussing a more suitable basis for determining such profit the text includes the phrases 'the actual trading profit retained by the proprietary body', 'the profit accruing to the shareholders' and 'the share of profits accruing to the proprietary body'. No definition of those phrases is given, but their apparent meaning, read in conjunction with recommendation (*b*), is such profits as become applicable to or for the benefit of shareholders and, being part of the surplus revealed by the actuarial valuation, are arrived at after making all proper reserves whether in respect of liabilities or assets. In 1921 and in 1922 the offices requested that recommendation (*b*) be given legal effect. When the text of the relevant part of the Finance Bill, 1923, was available, the offices appear to have had no apprehension that that text might have a different meaning from the recommendation of the Report, and, without alteration, the text as drafted became section 16 of the F.A. 1923.

The basis of taxation described by Mr Holness was suggested by Sir William Elderton in the period preceding the Royal Commission of 1920 and has since been referred to as the Excess Interest basis. The basis entails the abolition of the present allowance for expenses of management and, in practice, would require some such limitation of the policyholders' rebate of tax as is now provided by the F. (No. 2) A. 1940. So arranged, the basis would, as Mr Holness has indicated, give an aggregate tax yield which should be satisfactory to the Revenue. It has the great virtue of protecting life assurance funds from insolvency through the effect of high rates of income tax. There are however serious difficulties in its practical application. It would not be satisfactory to make use of the mean fund in computing the amount of interest which is to be freed from taxation: the fund includes surplus to an extent which varies according to the views of the office and the period elapsing between one distribution of profits and the next. If, in lieu of mean fund, an attempt be made to use the actuarial valuation, it will be found that the existing wide range of bonus systems causes great difficulty in arriving at a valuation basis which will be fair as between one office and another. Apart from these considerations, a deeper-rooted obstacle lies in the effect on the taxation of industrial life assurance business of the abolition of the allowance for expenses of management which is an essential part of the basis: such effect has been referred to in the penultimate paragraph of page 60. The basis is not in accord with existing principles of taxation law and, although such an objection might not be insuperable, the absence of a satisfactory solution of the practical difficulties has the effect of restraining thought concerning the legal foundation which would be required to put the basis into practice. Thus, in spite of numerous arguments which can be urged in its favour, no progress has been made with a basis which, in its principal feature, cannot fail to be attractive to actuaries.

I have a warm appreciation of the very generous manner in which the paper has been received. Also, in another and less personal aspect, the discussion has been gratifying. It has disclosed the existence, with reference to a subject which has frequently been controversial and always complicated, of a much greater measure of concordant opinion than I expected to find. I trust that my reply to the discussion will not be considered to be abrupt: I am conscious that much more could be said both in favour of and against some of the points which have been raised. Members cannot fail to feel grateful to the President for the review and the balanced summary of considerations which he has given. Is it too much to hope that his continued interest in a subject in which he has had so much experience may lead to practical developments which will have the happy result of rendering the paper, within a period of a few rather than many years, at least partly out of date?