JIA 93 (1967) 25-77

THE FINANCE ACT, 1965 AND ITS EFFECT ON LIFE OFFICES AND THEIR POLICYHOLDERS

By E. H. POTTER, F.I.A., F.C.I.A.

[Submitted to the Institute, 28 November 1966]

INTRODUCTION

The Finance Act, 1965 (which will be referred to in this paper as 'the Act') introduced two major changes into the United Kingdom system of taxation: firstly, it introduced a corporation tax applicable to company profits in place of the income tax and profits tax to which those profits were previously subject; and secondly, it imposed a charge to tax on all capital gains, with certain exceptions, whether these gains accrued to a company or to an individual. The objects of these changes and the various associated arrangements were:

(1) To make the tax system more equitable by bringing into charge certain capital gains, frequently speculative gains, which had previously escaped tax altogether.
(2) To make the tax system more simple in some respects by separating the taxation of companies from the taxation of individuals and by levying corporation tax on a current year basis.
(3) To encourage the retention of profits by companies.
(4) To improve the country's immediate balance of payments by rendering overseas investment less attractive.

THE NEW LEGISLATION GENERALLY

Taxation of company profits

2a. Under the old system a company in paying income tax on its profits was in effect regarded as suffering that tax on behalf of its shareholders. When it declared a dividend, therefore, the company could use its net profits to pay a net dividend and it was not obliged to account to the Revenue for tax notionally deducted from the gross dividend. The shareholder receiving the net dividend was similarly not liable for any further income tax, but a shareholder liable to surtax would pay that tax on the gross amount of the dividend. Shareholders not liable to income tax or liable only at a reduced rate were able to recover from the Revenue some or all of the income tax notionally deducted from the gross dividend. If a company operated overseas and thus suffered foreign tax on a part of its profits, that tax would rank under double taxation relief arrangements as a credit against the company's liability to U.K. profits tax and income tax

on those profits. Thus the U.K. income tax actually suffered by the company might be less than tax at the full standard rate on its profits and so, in order to protect the Revenue, the shareholders' right of recovery of tax was limited to the 'net U.K. rate' suffered by the company. Investment allowances also served to reduce the tax payable by the company, but no further restriction on the shareholders' right of recovery was introduced on this account. This could mean that the Revenue might be called upon to refund tax which they had never received, though this feature was not necessarily objectionable if the investment allowances were regarded as in the nature of a Government grant to encourage expenditure on plant and machinery.

2b. The concept that the company was paying tax on behalf of its shareholders was imperfect in its application because, of necessity, profits retained by the company could be subjected to income tax at one rate only, namely the standard rate of income tax, and while this rate was appropriate for some shareholders, it was either too high or too low for many others. Furthermore, the concept had been blurred for nearly 30 years by the imposition of taxes applicable to companies only. The last of these taxes before 1965 was profits tax.

2c. Against this imperfect philosophical background and the administrative complications involved in the old system, it is, perhaps, not surprising that a move should have been made to separate entirely company and individual taxation. Companies are now liable to only one tax on their trading profits, namely corporation tax, which is currently at a rate of 40% as against the old income tax and profits tax which together amounted to 56¼% in 1965–66. On the other hand the corporation tax paid by a company cannot be used to offset income tax on dividends paid by the company which are now assessable under a new Schedule F. The result is that profits retained by a company suffer tax at a rate of 40% only, whereas profits used to provide dividends suffer tax at a rate of 64¾%, that is corporation tax of 40% on the gross profits plus income tax at 41¼% on the net profits. Whether the company and its shareholders are better off immediately under the new system, therefore, depends on the proportion of its gross profits which the company distributes. If it is less than about 40% then the taxation burden is less than under the old system; if it is more than 40% the burden is heavier. In making this calculation profits should be determined before deduction of preference dividends, which are not deductible for corporation tax purposes, and the distributed profits should be regarded as including preference dividends. This ignores complications arising from capital allowances, franked investment income and overseas income.

2d. It is apparent that the new system, by its nature, imposes a penalty in the shape of the Schedule F liability on distributions by companies and thus accords with the third of the objects listed in the Introduction. However, the inducement to retain profits applies indiscriminately to all com-

panies, the inefficient as well as the efficient, and it has been argued that it would be better from the point of view of the national economy to place a smaller burden on distributions so that capital might be attracted to those firms and industries where it could most profitably be employed. It has been suggested that a rather higher rate of corporation tax could be imposed, some credit for this tax being allowed against income tax on distributions. This would, in effect, be a reversion to the old system and would revive the old net U.K. rate complications. A possible compromise would be to have a special reduced rate of income tax applicable only to distributions by U.K. companies.

Investment income of companies

3a. Under the old system companies received investment income mainly under deduction of income tax at the standard rate. Having already suffered income tax, this income was not included in the company's Case I computation for income tax purposes, but unfranked income was included in the profits tax computation. Franked income, that is income in the form of preference or ordinary dividends from other companies liable to profits tax, was exempt from that tax. Thus franked investment income passing through the hands of a company suffered no tax penalty on this account, but unfranked investment income, apart from the exceptions mentioned in the next two paragraphs, was penalized by the charge to profits tax. In other words the net benefit to shareholders arising from unfranked investment income was less than could have been secured by direct investment by the shareholders.

3b. Overseas income was liable to income tax and profits tax in the hands of a U.K. company, but as relief was given not only for direct or withholding taxes but also in the case of the more important territories for underlying taxes, that is taxes suffered on profits in the country of origin, this liability was frequently nil. Where this was so the U.K. shareholder of the company clearly did not suffer; but where the foreign taxes were not sufficient to cover both profits tax and income tax so that the company was left with a residual liability for U.K. tax, the shareholder was worse off than if he had invested direct, because of the profits tax element.

3c. Apart from double taxation relief two other factors also served to minimize the importance of the profits tax charge on unfranked income. Firstly, if the income were used to offset charges on income or expenses or trading losses, no profits tax liability would arise. Secondly, profits tax was at the relatively modest rate of 15% though this was effectively about 25% after allowing for grossing up by income tax.

3d. In passing to the new system, the legislature appeared to follow the broad principle that, subject to an exception in relation to non-resident companies, any profits which had previously attracted profits tax should, under the new system, be subjected to corporation tax; and that profits which had been franked for profits tax purposes should, subject to a minor

exception arising from a redefinition of franked investment income, escape corporation tax. Thus, dividends from other U.K. companies, which are now the only form of franked investment income, are not liable to corporation tax and one might have expected that the receiving company, not being liable to income tax on its income, should be able to recover the income tax deducted. However, this could lead to a deferment of the ultimate charge to income tax and, presumably for this reason, Section 48(1) of the Act provides that a company shall not be able to recover income tax suffered on franked investment income, except to the extent that such income can be set against the company's own distributions. Any surplus franked investment income not required for Section 62 purposes (see section 4 below) is then carried forward to offset future distributions. In this way the Act ensures that as regards franked investment income the shareholder does not suffer merely because a company is being used as a channel for his investment in other companies.

3e. The position is, however, different in relation to unfranked investment income. This was subject to profits tax under the old system and is now subject to corporation tax. Any U.K. income tax suffered by deduction can be recovered by the receiving company, once the corporation tax liability has been settled (Section 48(6)), but if and when the income is passed on to shareholders in the form of dividends, the company has to account for income tax under Schedule F. In other words, unfranked investment income accruing to a shareholder through the medium of a corporate investor suffers both corporation tax and income tax, whereas unfranked income accruing directly to an individual suffers only income tax. This discrimination is no different in principle from that which obtained under the old system, but the practical effect is apt to be very different for two reasons. Firstly, corporation tax is at the rate of 40% which is considerably higher than the old rate of profits tax even when grossed up for income tax. Secondly, as regards portfolio investment overseas it is the intention, as double taxation agreements are re-negotiated, to withdraw relief for underlying taxes, and in any event overseas taxes suffered by a U.K. company cannot be used to offset its Schedule F liability. Therefore, overseas income passing to a shareholder through the medium of a U.K. company will suffer corporation tax and income tax less relief (against corporation tax) for the withholding tax suffered; whereas an individual in the U.K. investing directly in the overseas company would only suffer income tax on dividends received and would receive credit for the withholding tax deducted. This point is of importance to investment trusts, for example, with a large proportion of overseas holdings.

3f. In these circumstances it becomes important to consider whether the additional tier of taxation which is introduced when unfranked investment income passes through the hands of a company can be justified. It can be argued that the mere fact of incorporation should give rise to an additional

tax burden; that this is accepted in relation to an ordinary trading operation and that unfranked investment income must be subject to the same rules as ordinary trading profits. This argument is a dubious one, however, because shareholders in an ordinary trading company do derive some benefit from incorporation; their liability is limited, retained profits are taxed only moderately, the existence of a share capital and the possibility of a further issue facilitate the expansion of the business and the original proprietors can split their interests among their families with consequent Estate Duty and other advantages. These considerations either do not arise or apply with less force when the company is, for example, an investment trust acting merely as a channel for the investment of the funds of its shareholders. In such circumstances the additional burden of taxation serves only to penalize the investor of limited means, for whom an investment trust is particularly suitable, as compared with the richer investor with sufficient resources to invest directly in the underlying securities of the trust.

3g. The different tax treatment of franked and unfranked income has undesirable repercussions in other directions. To companies with insufficient franked investment income to cover their distributions, a new investment yielding additional franked income is worth much more than an investment yielding the same amount of unfranked income. If corporation tax is at the rate C per unit, £100 of franked income is, in fact, worth $\frac{£100}{1-C}$ of unfranked income. If, on the other hand, the company has a surplus of franked investment income or if the company is a typical proprietary life office, in which only a small part of the investment income accrues to shareholders, the attraction of franked income is considerably diminished. Finally, to individuals and to 'gross funds' such as pension funds and charities, as well as mutual life offices, franked and unfranked income are equally valuable. Admittedly this type of situation in which tax considerations influence one investor in one direction and another investor in a contrary direction is no new thing, but it is unfortunate if a type of investment particularly suited on other grounds to an investor's needs is rendered unattractive to him by tax considerations which are irrelevant for the other types of investor; and any narrowing of markets is also a bad feature. Furthermore, owing to the divergent interests of shareholders, difficult situations can arise where, for example, it is desired to repay an issue of preference shares. Finally, for many investors a bias against unfranked income has been created which is apt to prejudice the gilt-edged and debenture market and may render Government borrowing more costly than it otherwise would be.

3h. A simple and equitable solution to all these problems would be to treat all types of investment income in the same way as franked income. In other words, investment income received by a company should be free of corporation tax but should suffer income tax immediately, usually

by deduction but, if necessary, by direct assessment. The income tax suffered should then be used to offset the Schedule F liability in the same way as tax on franked investment income is used at present. Such a system would yield less tax than the present system but this could be corrected by a small increase in the rate of corporation tax. One other small problem would remain. A company receiving overseas income would, in the same way as an individual, claim credit for the withholding tax suffered against its own liability to income tax. The actual U.K. tax suffered would then be at a rate lower than the full standard rate. However, provision could be made for any subsequent recovery by set-off against the Schedule F liability to be at the net U.K. rate suffered originally. This would disturb to some slight extent the suggested principle that investment income should not suffer any tax penalty on passing through the hands of a company, but the alternative solution of allowing the company to set-off tax at the full standard rate against its Schedule F liability and then restricting the shareholder's right of recovery on similar lines to the old net U.K. rate procedure, would destroy one of the main objects of the new system, namely, complete separation of company and personal taxation.

Relief against franked investment income

4a. It has been mentioned that in general companies are unable to recover income tax suffered on their franked investment income, except by set-off against their Schedule F liability. However, Section 62 of the Act allows certain items to be set against surplus franked investment income (that is franked investment income in excess of that needed to cover the Schedule F liability) if there are no profits subject to corporation tax available for this purpose. These are:

(1) charges on income (to which reference is made later);
(2) expenses of management of investment companies and life assurance companies;
(3) certain capital allowances; and
(4) trading losses.

4b. Where any of these items are set against franked investment income the company is entitled to recover the income tax suffered. If, at some later stage, dividends exceed the available franked investment income, including any surplus carried forward from previous years, the items mentioned above can, to the extent of the excess, be reinstated as a charge on profits for corporation tax purposes.

Charges on income

5. Under the old system, charges on income in the shape of interest, annuities, etc. were paid by companies under deduction of income tax at the standard rate. If charges were paid out of profits or gains brought into charge to tax, the company was entitled under the Income Tax Act

1952, Section 169, to retain the tax deducted; otherwise it was obliged under Section 170 to account to the Revenue for the tax deducted. Under the new system, a company is subjected to corporation tax, not income tax, on its profits and so the retention of income tax on charges under Section 169 is no longer appropriate. Section 48(5) of the Act accordingly provides that no payment by a U.K. company after the year 1965–66 is to be treated for income tax purposes as paid out of profits or gains brought into charge to tax. Instead the company is required to account for tax on charges under Section 170, but it is able to treat these charges as a deduction from its total profits for corporation tax purposes (Section 52(1)). If such profits are insufficient the company can have recourse to its surplus franked investment income for the year (i.e. excluding any surplus carried forward from previous years) as explained above.

Double taxation relief

6a. As mentioned in item (4) of the Introduction, the new tax system seeks to create a bias against investment overseas, or at least to correct what may previously have been a bias in favour of such investment. For portfolio investment the instrument adopted for this purpose, namely the disallowance of underlying taxes as a credit against the tax liability of the U.K. investor, is in keeping with the philosophy of the new system, which seeks to divorce the taxation of a trading company from the taxation of its shareholders. Withholding taxes, on the other hand, being, in effect, a tax on distributions and thus a direct burden on shareholders, are still allowed as credits against U.K. taxation of the income in question, that is to say against corporation tax where the investor is a company or against income tax where the investor is an individual. These changes are being introduced in stages as double taxation agreements are re-negotiated.

6b. If a U.K. company operates overseas then the profits it earns overseas, equally with the profits it earns in the U.K., are subject to corporation tax but credit is allowed for all qualifying overseas taxes against U.K. tax on the same profits. The snag here is that overseas taxation will frequently exceed corporation tax on the profits concerned and, apart from transitional arrangements which will be mentioned later, no credit is allowed for the excess or 'overspill'. If a company chooses to conduct its overseas operations through the medium of another company in which it controls at least 25% of the voting power, then the investment is regarded as a 'trade investment' and not portfolio investment, and the parent company is allowed credit for underlying taxes in the same way as if it operated direct. The minimum figure of 25% is reduced to 10% if the paying company is resident in the Commonwealth and may similarly be reduced to 10% if the terms of the double taxation agreement with any particular country so provide. The revised double taxation agreement with the U.S.A. is a case in point.

6c. A company cannot use taxes suffered overseas as a credit against

its liability to account for tax on its own distributions under Schedule F. Accordingly there are no longer any net U.K. rate provisions operating to restrict a shareholder's right of recovery of income tax in appropriate circumstances.

6d. Two other features of the Act in keeping with the philosophy and aims of the new system may be mentioned. Firstly, the special status of Overseas Trading Corporations which previously enjoyed freedom from U.K. tax on their trading income, though suffering tax under Case VI on their dividends, subject to double taxation relief, has been withdrawn. Secondly, the Income Tax Act 1952, Section 201, which previously allowed relief in respect of dividends received from overseas companies for U.K. income tax suffered on the profits of those companies, is no longer effective.

Chargeable gains

7a. One of the major innovations introduced by the Act was the taxation of nearly all capital gains accruing either to individuals or to companies.

7b. As regards individuals the short-term gains tax introduced in the Finance Act 1962 continues, but there is a new uniform time limit of one year in place of the previous time limits of three years for land and six months for assets other than land. The scope of the tax has been extended to include tangible movable property (chattels) and business assets, but there are certain exemptions, for example chattels realizing less than £1,000 and motor cars.

7c. The new long-term tax, known as capital gains tax, applies in relation to individuals to all realized capital gains, with certain exceptions, falling outside the time limit of the short-term tax. The main exceptions, apart from those mentioned in the last paragraph, are the principal private residence of the individual, national savings certificates and the like, the first £5,000 of any gains accruing at death, normal life assurance and deferred annuity policies and all other insurance policies, though sums received under non-life insurance policies may be regarded as consideration for the disposal or part disposal of the insured asset. The exemption in relation to life and deferred annuity policies is conferred by Section 28 of the Act and applies to all such policies unless the person realizing the policy is someone other than the original beneficial owner and he acquired his interest for a consideration in money or money's worth. The aim appears to be to exempt all life assurance and deferred annuity policies other than those acquired by a third party for investment purposes.

7d. The rate of capital gains tax chargeable on an individual is 30%, though there is an alternative basis of charge which is applied automatically if it is more favourable to the individual. This consists of treating one half of the relevant gains up to a maximum of £5,000 and the whole of any excess over £5,000 as an addition to income of the year in question and then determining the additional income tax and surtax that would be

payable on this assumption. This additional amount is then the capital gains tax payable, if less than tax at the flat 30% rate. Gains realized by individuals in any one year will usually total less than £5,000 and most of the individuals concerned will have a top rate of tax on income of less than 60%. It follows that the second basis of charge will apply in most cases and indeed the effective rate of tax will frequently be well below the maximum 30%.

7e. Prior to the Finance Act 1965, companies were subject to the short-term gains tax in respect of all realized short-term gains which accrued to them other than as trading receipts. This tax no longer applies to companies but all realized capital gains, irrespective of duration, are now treated as chargeable gains unless they are included in a profits computation. Either way all capital gains now become liable to corporation tax, though the amount of the gain may differ in the two cases if the asset was acquired before 6 April 1965, since a chargeable gain cannot exceed the gain arising after that date.

7f. For both individuals and companies chargeable gains in respect of quoted shares and securities acquired before 6 April 1965 are measured, in the first place, from the market value at that date. However, if the original cost of acquisition including expenses was greater than the April 1965 value, the gain is reckoned by reference to the original cost; while if the sum realized on disposal of the asset, after deducting the expenses of sale, is intermediate between the original cost and the April 1965 value no gain or loss is deemed to have arisen. Similarly, if the original calculation by reference to April 1965 value shows a loss, that loss is reduced or eliminated for tax purposes if the original cost was lower than the April 1965 value. Losses arising in any period may be set against profits of the same class arising in that period, but not against other classes of profit. Losses may however be carried forward without time limit to be set off against future profits of the same class.

7g. Where part of a holding of shares or securities is realized it becomes necessary to determine what fraction of the original cost is attributable to the part sold. Schedule 6, para. 7, of the Act provides that this fraction shall be $\frac{A}{A+B}$ where A is the consideration received for the part-disposal and B is the market value at the date of disposal of the remainder of the holding. In practice, however, it will normally be sufficient to work on the ratio of the number of shares realized to the total number held immediately before the part-disposal.

7h. Where a number of purchases have been made of a particular share or security the total holding is treated as a single asset or 'pool' which grows or diminishes as shares are bought and sold. This is the normal method used for determining profits entering into a profits computation under Case I or Case VI of Schedule D, but complications arise in relation to chargeable gains, i.e. capital gains taxable as such under the 1965

legislation and not gains entering into a profits computation, if a part or the whole of the holding was acquired before 6 April 1965. In the first place only that part of a gain which arises after 6 April 1965 is taxable and so, for chargeable gain purposes, that part of the pool which relates to shares acquired before that date is treated as having been bought at a cost equal to market value on that date. Secondly, allowance has to be made for the fact that in some circumstances as described above the true original cost has to be brought into the calculations. For this purpose the F.I.F.O. (first in, first out) principle is applied to shares acquired before 6 April 1965, so that (1) the shares held on that date are identified with the most recent acquisitions prior to that date and (2) shares subsequently sold are identified with the earliest holdings in the pool. Rights issues, however, are treated as if they were purchased at the same time as the original holdings.

7j. If *A* represents the original gross price of a holding of shares, *B* the market price at 6 April 1965 and *C* the net price realized on a sale, the first step is to determine whether *B* is intermediate between *A* and *C*. If it is, then any chargeable gain or allowable loss arising is determined in relation to the appropriate fraction of the total notional cost of the pool as a whole. The shares are then removed from the pool at the same cost figure. If *A* is intermediate between *B* and *C*, the gain or loss is measured by reference to the difference between *C* and *A*. Finally, if *C* is intermediate between *A* and *B* there is deemed to be neither gain nor loss. In the two latter cases the shares are removed from the pool at their market value at 6 April 1965; that is to say, the pool is placed in the same ultimate position as if the shares in question had never formed part of it. Where, by applying the F.I.F.O. principle, a sale is identified with two or more purchases, each purchase is dealt with separately in the calculations.

7k. This method can produce seemingly capricious results. For example, if *B* is greater than *A* and *C* slightly less than *B* there will be no charge to tax. However, if *C* is slightly greater than *B* any tax payable will be related to the difference between *C* and the notional pool price. If there have been new purchases since April 1965 at prices differing greatly from *B* there could now be either a comparatively large chargeable gain or a comparatively large allowable loss. This is not as anomalous as it seems because the shares are removed from the pool at different values according to the method applicable; and the end result after the entire holding has been disposed of is not unreasonable. At the same time variations in total liability can occur when parcels of shares are sold at varying prices as compared with the liability that would have arisen if the total holding had been sold in one operation to realize the same total sum. The difference arises because of the effect of the 'neutral zone' between *A* and *B* but it can never exceed tax on an amount equal to the sum of the neutral zones for all shares held at 6 April 1965.

7m. Unquoted shares are dealt with rather more simply. Shares held on

6 April 1965 are subject to the F.I.F.O. rules outlined above, but they are excluded from the pool of shares acquired subsequently. Sales after 6 April 1965 are then identified on F.I.F.O. principles and dealt with accordingly until the whole of the pre-April 1965 holding is disposed of. The chargeable gain at each sale is the difference between the proceeds of sale and the original cost multiplied by a factor equal to the time from 6 April 1965 to the date of sale divided by the total period for which the shares have been held. This is known as the 'time apportionment' basis and it has the virtue of avoiding the necessity to estimate an April 1965 value. However, if the taxpayer can establish what that value was he is at liberty to substitute it for the original cost, but without the time apportionment adjustment.

7n. There are special rules applicable to leases and to wasting assets generally. The governing principle is that the consideration received for the disposal of the asset is compared not with the original cost but with such part of that cost as is regarded as corresponding to the unexpired term of the asset.

7p. As has been mentioned, chargeable gains accruing to a company are subject to corporation tax and the net gains, when they are passed on to shareholders in the form of dividends, attract income tax under Schedule F. Where a company makes capital profits out of its investments, therefore, those profits will ultimately suffer considerably more tax than if the shareholders had held the investments direct. This anomaly is analogous to that involved in the present treatment of unfranked income which has already been discussed. The anomaly is recognized in relation to investment trusts and unit trusts, which not only pay corporation tax on chargeable gains at a limited rate equal to the maximum individual rate of capital gains tax, but also issue to their shareholders or unitholders certificates showing net gains realized (after deduction of tax), these net gains being treated by shareholders and unitholders as additions to cost for the purposes of their own tax liability. In this way double taxation of capital gains is avoided entirely, though the rate of tax suffered by the trust, 30% at present, will in most cases be greater than the rate to which the shareholder or unitholder would be liable in his own right.

7q. In the case of an ordinary trading company, investments may be held as part of the trading activity and any capital gains earned on those investments would then be included in the normal profits computation under Case I of Schedule D. Any gains arising on investments held outside the trading activity would rank as chargeable gains and thus attract corporation tax by a different route. The latter situation closely resembles that of a unit trust and it seems unfair that the ultimate tax liability on capital gains for the company and its shareholders should be so much heavier. On the other hand any amelioration in relation to 'non-trade' investments should in equity be extended to 'trade' investments, partly because the distinction between the two types is sometimes quite arbitrary and partly

because, in the last analysis, the investments are being made in each case for the benefit of the shareholders.

7r. These thoughts lead to the conclusion that ideally any capital gains realized by a company in connexion with its portfolio investments should suffer tax at a rate no heavier than the capital gains tax rate applicable to individuals and, furthermore, that when these gains are passed on to shareholders they should not attract further taxation. In the first place, therefore, capital gains on investments should suffer tax at a rate of 30% only; and when those gains are passed on to shareholders the relevant part of the distribution should be free of income tax. This would be administratively complicated and a reasonable compromise would be to subject dividends to income tax under Schedule F in the normal way but to allow the company a credit against its Schedule F liability for the tax it had already suffered on the relevant gains. In other words these gains would, for Schedule F purposes, be of the same nature as franked investment income.

Chargeable gains and British Government securities

8a. In order to combat any suggestion of unfairness, the Government introduced provisions into the Act allowing price movements of British Government securities of which any part was issued at a discount prior to 6 April 1965 to be ignored for chargeable gain purposes within certain limits, namely the lowest issue price and the ultimate redemption price. Variations in price within this 'neutral zone' are ignored in calculating both chargeable gains and allowable losses. As a result securities in this category with low coupon rates are now attractive both to companies and to individuals subject to high rates of tax because of the prospect of tax-free capital gains. By switching from one security to another as redemption occurs it should be possible to preserve this advantage up to the year 2004 which is the final redemption date for 3½% Funding Stock 1999/2004.

8b. Apart from the neutral zone referred to in the last paragraph many investors will have holdings of British Government securities which, at April 1965 prices, were worth less than the original cost. Where this is so, the difference between the two values also ranks as a neutral zone in accordance with the principles described in § 7f. As a result many investors find themselves, in effect, 'locked in' with certain of their holdings, purely because of tax considerations.

8c. Against this background it is questionable whether in practice it is really desirable to tax capital gains arising on British Government securities. The relevant tax yield must be very small and in order to achieve that yield both the taxpayer and the Revenue are involved in a vast amount of unproductive work. If gains on British Government securities were to be exempt it would remove the inhibitions which exist in the gilt-edged market at the moment and it might well facilitate future Government borrowing.

Initial and transitional arrangements for companies

9a. The last year for which companies were liable to income tax on their profits was 1965–66, the relevant tax being payable on 1 January 1966. The profits used as a measure of the profits for 1965–66 were the actual profits of the company's year of account ending in 1964–65. Thus if a company made up its accounts on a calendar year basis the actual profits of the calendar year 1964 were the basis of the 1965–66 assessment.

9b. Corporation tax is payable in respect of all profits earned after the end of the period which was the basis of charge to income tax in 1965–66. In the example in the last paragraph profits from 1 January 1965 onwards are subject to corporation tax on a current year basis, the first payment, relating to the calendar year 1965, being due on 1 January 1967. For corporation tax purposes the financial year runs from 1 April to 31 March, the profits earned in any accounting period being split on a time basis between the relevant financial years to determine the actual tax liability.

9c. Profits tax came to an end on 5 April 1966, but any profits arising before that date which are subject to corporation tax are exempt from profits tax.

9d. Investment income generally was dealt with on the old basis, that is income tax and profits tax, up to 5 April 1966 and on the new basis thereafter. However, any source of income which was assessable to income tax for 1965–66 on a preceding year basis is liable to corporation tax from 6 April 1965.

9e. Chargeable gains are liable to tax from 6 April 1965, but any such gains accruing before the company came within the charge to corporation tax are subject to capital gains tax (not corporation tax) at 35%.

9f. Other provisions designed either to relieve hardship for the taxpayer or to protect the Revenue are contained in Sections 83–85 of the Act. Section 83 is concerned with dividend payments in 1965–66 in excess of a certain standard. Dividends paid in that year do not involve the company in any income tax liability under Schedule F, but to avoid excessive forestalling any excess dividends as defined in the section are treated as if they were paid on 6 April 1966.

9g. Section 84 is concerned with relief for 'overspill'. Under the old system a U.K. company operating overseas was able to treat taxes suffered locally on its profits as a credit against its U.K. liability for profits tax and income tax on those profits; and no further liability to income tax arose when the profits were passed on to shareholders by way of dividend. Under the new system overseas taxes rank as a credit against the company's liability for corporation tax, but the company is obliged to account to the Revenue under Schedule F for the full amount of income tax on its dividend, even though the foreign taxes suffered may exceed the corporation tax otherwise payable. In these circumstances, that is where there is an excess or 'overspill' of foreign taxes, transitional relief is allowed to a company over a period of seven years but the relief tapers off over the last

four years. Moreover, there are tax penalties if the company should increase its dividend during the transitional period.

9h. Section 85 is concerned with profits earned prior to 6 April 1966, on which income tax and profits tax have been suffered, but distributed thereafter with a consequent further liability to income tax under Schedule F. It might be thought that full relief from Schedule F tax should be allowed in these circumstances, but this would severely deplete the yield from income tax over the next few years and would render necessary temporary increases in taxation in other directions. However, Section 85 does grant a limited amount of relief in two separate sets of circumstances.

9j. Firstly, if a substantial part of a company's income in 1965–66 has borne income tax and profits tax, so that the tax suffered by the company is considerably greater than it would have been under the new system, there is available what is known as a 'one year surplus' relief. Subject to certain adjustments a proportion of the following items in respect of 1965–66, namely (1) income tax suffered on franked investment income, (2) profits tax paid and (3) the excess of income tax suffered on unfranked income arising in 1965–66 over tax at the corporation tax rate of 40%, is regarded as tax on a notional surplus of franked investment income to be set against the company's Schedule F liability in respect of 1966–67.

9k. Secondly, and as an alternative to the one year surplus relief, there is available a three year surplus relief. This arises only where dividends in the three years 1966–67 to 1968–69 inclusive exceed distributable profits for the same period. Any excess is then regarded as a surplus of franked investment income for Schedule F purposes to the extent that tax on the surplus does not exceed income tax borne by the company in the three years 1963–64 to 1965–66 inclusive after deducting all reliefs and tax recovered by deduction on charges and dividends.

TAXATION OF LIFE OFFICES

The pre-1965 position

10a. The taxation of life offices under the old system has been the subject of a number of papers to the Institute of which the most recent is by C. E. Puckridge (*J.I.A.* **84**, 166). It may however be helpful briefly to summarize the old procedures in a simple case where the office transacts ordinary life assurance and annuity business but no other class of business.

10b. Investment income was subject to income tax in the hands of the life office, mainly by deduction at source, but to some extent by direct assessment under Cases III, IV and V of Schedule D. This income was split between the Life Assurance Fund, the General Annuity Fund and the Pension Annuity Fund in proportion to the amounts of those funds. Relief was then granted, up to a specified limit, in respect of income from investments of the Foreign Life Fund, the income of the Assurance Fund and the General Annuity Fund being adjusted accordingly. The actual

income from each investment of the Life Assurance and Annuity Fund, after excluding Foreign Life Fund investments, was then regarded as attributable to the home Assurance Fund, the home General Annuity Fund and the Pension Annuity Fund in proportion to the amounts of those funds. Relief was then allowed in respect of all Pension Annuity Fund income.

10c. Home general annuities, up to the limit of the taxed income of the General Annuity Fund, were treated as charges on the income of the whole of the Life Assurance and Annuity Fund and income tax deducted was retained by the office accordingly. The office was, however, required to account to the Revenue for income tax on any general annuities in excess of the limit and also for tax on all pension annuities.

10d. The profits of the General Annuity Fund and the Pension Annuity Fund were then assessed ignoring expenses and excluding, in the General Annuity Fund computation, any excess of investment income over annuities paid out. The profits of both funds, after deducting the 'foreign proportion', were then subjected to tax under Case VI (the 'foreign proportion' is the ratio of Foreign Life Fund relieved investment income to total investment income).

10e. Expenses of management, less fines, fees and profits on reversions and adjusted to exclude the 'foreign proportion', were then relieved against all income remaining in charge to tax, including Case VI profits. This relief was not, however, given beyond the point at which the total tax borne by the company was equal to tax on the shareholders' profits as determined by a notional Case I computation (Income Tax Act 1952, Section 425(2)). Any expenses not ranking for relief by virtue of the limitation were carried forward without time limit.

10f. The notional Case I computation referred to in the last paragraph is a special form of profits computation differing from the normal Case I computation by virtue of the inclusion of investment income. Both computations would exclude profits reserved for policyholders and annuitants (Income Tax Act 1952, Section 427(1)). The notional computation is used not for purposes of assessment, but as a measure of proprietors' profits for various purposes. The normal Case I computation would almost invariably result in a loss, but the office is effectively precluded from using this loss for purposes of relief by virtue of the Income Tax Act 1952, Section 428.

10g. Double taxation relief was allowed in respect of overseas taxes (normally both underlying and withholding) suffered on overseas income, unless such income was otherwise relieved or was used to offset charges.

10h. Any income remaining in charge to tax, to the extent that it was deemed to pertain to policyholders, then attracted reduced rate relief; that is relief was given to the extent of the excess of the standard rate of tax over 7*s.* 6*d.* in the £ (Income Tax Act 1952, Section 427(2)). In the case of income subject to double taxation relief this relief was available only to the extent of the U.K. tax actually suffered.

10j. In relation to dividends received from a U.K. company any relief available, whether Pension Annuity Fund, management expenses or reduced rate relief, was limited to that company's net U.K. rate. Similarly, if charges were set against such dividends the receiving company was obliged to account to the Revenue for the difference between the standard rate of tax and the appropriate net U.K. rate.

10k. Profits tax was payable on the shareholders' share of total profits, except to the extent that their share could be covered by franked investment income attributable to shareholders.

Investment income

11a. Under the 1965 legislation, investment income accruing to a life office is dealt with initially in the same way as similar income accruing to any other company. In other words franked investment income is exempt from corporation tax in the hands of the office, but the office is unable to recover the income tax deducted except by way of a specific relief; while unfranked investment income is subject to corporation tax, any income tax or withholding tax deducted at source being recoverable when the corporation tax liability is settled.

11b. There is one other category of investment income, namely group income. This is income received from a U.K. subsidiary in respect of which a group election has been recognized under Section 48(3) of the Act. Such income is paid by the subsidiary to the parent without deduction of income tax and is free of all tax in the hands of the parent. In this way monies can pass from subsidiary to parent without a tax liability being incurred, the income tax liability on distributions under Schedule F being deferred until the relevant profits are passed on to shareholders by the parent company.

11c. Three special points arise in relation to group income, two being peculiar to life offices. The general point is that where a subsidiary receives franked investment income and passes it on to its parent there is normally a positive disadvantage in regarding this as group income because the income tax borne by the subsidiary is never set against Schedule F tax on distributions. In other words the income, in passing from subsidiary to parent, loses its character as franked investment income and a potential tax benefit is lost. To overcome this a proviso to Section 48(3) allows a subsidiary to pay any amount of dividends it pleases under deduction of income tax, in spite of the fact that there is a group election in force. Where it does so, the amount in question is treated not as group income but as franked investment income.

11d. The second point, which is peculiar to life offices, is that the bulk of the investment income of such offices, including group income, is used to provide benefits to policyholders and does not find its way to shareholders at all. A group election is therefore particularly valuable to a parent life office, since it enables such an office broadly speaking to avoid a layer of taxation instead of merely deferring it.

11e. The third point is that a group election is permissible only in relation to dividends received on investments the sale of which at a profit would not be treated as a trading receipt (Schedule 12, para. 7(1)). A life office holds investments as part of its trade and it might be thought, therefore, that no investments of a life office could be the subject of a group election. However, it is possible for a life office to hold investments in effect as part of its fixed assets, where for example it is using the subsidiary to carry out its own functions or as an adjunct to those functions. In such circumstances a group election is normally permitted.

Chargeable gains

12a. These are a completely new element in the post-1965 situation. Profits or losses on the sale of investments, reckoned by reference to original cost, have in the past been included in Case VI computations for annuity funds, in so far as those profits or losses related to the annuity funds. This will continue in the future, as will the inclusion of all such profits or losses in actual or notional Case I computations. However, capital profits or losses accruing to the life fund, as opposed to the annuity funds, have generally escaped tax in the past because only in very exceptional circumstances have there been actual Case I assessments. Furthermore the short-term gains tax introduced in 1962 did not affect proprietary life offices because their capital profits are trading receipts and were therefore exempt, even though for the reason just explained they may not have been otherwise taxable. There was also a specific exemption from the short-term gains tax for mutual life offices. The Finance Act 1965, on the other hand, treats as chargeable gains all capital profits accruing to a company unless those profits are actually included in a profits computation (Schedule 6, para. 2(1)). Although there is normally no actual Case I computation capital gains are included, at least in theory, in the notional Case I computation required to determine, inter alia, the limit on the management expenses claim. Section 69(2) specifically provides that such inclusion shall not of itself remove such gains from the 'chargeable gain' category. The end result is that, with very rare exceptions, capital gains accruing to the life fund are taxable as chargeable gains and to the annuity fund as trading profits.

12b. The method by which the chargeable gain accruing on the disposal or part-disposal of an asset is calculated has already been explained in section 7 above. It involves the creation of a pool, calculated on a different basis from the pool used to determine capital gains to be included in the annuity fund Case VI computations. In the usual way where life and annuity fund investments are not separated this will mean that two separate pools will have to be maintained for every investment held in the combined fund on 6 April 1965 until the total holding, including any future purchases, has been realized. As time goes on and further purchases and sales occur the gap between the average cost figures of the two pools

will tend to narrow and it is to be hoped that ultimately it will be possible to negotiate with the Revenue for an amalgamation of the two pools.

12c. The rate of corporation tax applicable to the chargeable gains of a life fund depends in the first place on whether those gains belong to, or are allocated to, or reserved for, or expended on behalf of policyholders. If they do accrue to policyholders in any of these ways the rate is limited to 37½% in the same way as the rate of tax on policyholders' investment income is limited (Section 69(6)). Furthermore, by virtue of the Finance Act 1966, Schedule 5, para. 8 the rate cannot exceed the maximum rate of capital gains tax applicable to individuals. Thus the rate is either the corporation tax rate or 37½% or the maximum capital gains tax rate, whichever is the lowest. In present circumstances the rate is 30%.

12d. Chargeable gains, if any, accruing to shareholders are taxable, along with other sources of profit, at the full corporation tax rate.

Foreign Life Fund relief

13a. Relief of tax is allowed, as in the past, on income accruing from investments earmarked for the Foreign Life Fund, subject to the proviso that the income relieved must not exceed the total life and annuity investment income reduced in the ratio of the Foreign Life Fund liability to total life and annuity funds (Income Tax Act 1952, Sections 429 and 437). In practice the procedure adopted is to earmark each year appropriate securities (i.e. overseas securities or British Government securities on which interest is payable gross to overseas residents) sufficient to produce income up to the requisite limit.

13b. Chargeable gains arising in connexion with the investments of the Foreign Life Fund are also relieved of tax, subject to a similar overriding limit to that described above (Section 69(3)(d)). In other words chargeable gains are relieved only to the extent of world-wide chargeable gains multiplied by the ratio mentioned above.

Annuity funds

14a. In general the Act sought to preserve as far as possible the old basis of taxation of annuity funds, with the exception of a new relief in relation to the General Annuity Fund. Where investment income of this fund was in excess of general annuities paid out, Section 69(7) provided that the excess, to the extent that it consisted of franked investment income, should be relieved of income tax. The reason for this relaxation is obscure, but it may have been thought inappropriate that part of the General Annuity Fund income should suffer income tax when fundamentally, in the long run, annuity funds are taxed only on profits. In other words the purpose of the legislation may have been to substitute corporation tax for income tax on the income concerned. However, the practical effect was that virtually all General Annuity Funds could look forward to gross investment income indefinitely in spite of the fact that untaxed cash sums

could be paid out of the fund. Not surprisingly, therefore, the relief was withdrawn by the Finance Act 1966, Schedule 5, para. 9 (1).

14b. In future a company will be required to account to the Revenue under the Income Tax Act 1952, Section 170, for tax deducted from all general annuities. However, Section 69(3)(b) of the Act enables a company to treat as a charge on its income the whole of such general annuities up to the limit of the investment income of the General Annuity Fund, excluding group income. Although such investment income is used as a measure of the general annuities ranking as charges, this income is not necessarily, or even usually, the income against which the charges are set for purposes of relief. In fact, as in the past, the whole of the taxed investment income of the Life Assurance and Annuity Fund is available for this purpose and in addition any chargeable gains and the Case VI profits of both the General Annuity Fund and the Pension Annuity Fund are now available. The actual procedure is to set the charges as far as possible against income subject to corporation tax (including chargeable gains and Case VI profits), any balance being set against franked investment income under Section 62. In practice this will almost always mean that the income relieved will consist entirely of income subject to corporation tax.

14c. As in the past a company will be entitled to full tax relief on the investment income of the Pension Annuity Fund, whether the tax suffered is corporation tax or income tax. It will also continue to be liable to account for income tax deducted from pension annuities under the Income Tax Act 1952, Section 170.

14d. The Case VI profits of both the General Annuity Fund and the Pension Annuity Fund will be determined broadly on the same lines as in the past. However, the Finance Act 1966, Schedule 5, para. 9(5) introduces a concession in relation to the Pension Annuity Fund which will be of value to proprietary offices. This permits the office to refrain from claiming relief in respect of a certain part of the franked investment income of the Pension Annuity Fund, with a corresponding diminution in the Case VI profit. In the limit the Case VI profit may be reduced to nil by this means and the franked investment income left in charge to income tax correspondingly increased. The advantage to the office of this procedure is explained in § 18f.

14e. Group income attributable to either the General Annuity Fund or the Pension Annuity Fund originally fell to be included in the Case VI computation by virtue of Section 69(5) of the Act. This was in sharp contrast to the treatment of an ordinary trading company, which was not required to bring such income into its Case I computation. The position has been rectified by the Finance Act 1966, Schedule 5, para. 9(2) and (6) which excludes such income from both Case VI computations.

14f. As in the past, Case VI profits of both the General Annuity Fund and the Pension Annuity Fund will be reduced by the foreign proportion, that is the ratio of Foreign Life Fund relieved investment income to total

investment income. Moreover, reduced rate relief (i.e. relief in respect of any excess of tax over 7*s.* 6*d.* in the £) will be available except to the extent that any part of the profit passes to shareholders.

Expenses of management

15a. As in the past a life office will be able to claim relief of tax by setting off its expenses of management against its investment income and its annuity profits (Section 69(1)). Additionally, in future it will be able to set its expenses against its chargeable gains. As before expenses eligible for relief will be world-wide expenses reduced by the foreign proportion, that is the ratio of Foreign Life Fund relieved investment income to total investment income.

15b. Expenses eligible for relief will, in the case of a proprietary office, continue to be limited by reference to a notional Case I computation, so that tax will be paid on an amount at least equal to the shareholders' share of total profits. Section 69(2) of the Act is the relevant sub-section, but the wording used, taken in conjunction with Section 69(3)(a), appears to establish a procedure which is inconsistent with the general pattern of reliefs available to an ordinary trading company. The sub-section provides that the corporation tax paid by a life company shall not be less than it would have been had the company been charged to tax under Case I of Schedule D. This in itself is innocuous enough, because an actual Case I computation would exclude franked investment income and indeed any other income which had already been taxed. However, Section 69(3)(a) gives the Revenue power to insist that franked investment income shall be included in the computation, and unless such income is included Section 69(2)(a), which is designed to protect the Revenue against excessive relief of franked investment income under Section 62, becomes ineffective. At the time of writing the exact procedure to be adopted has not yet been agreed with the Revenue, but if in fact they insist on corporation tax being paid on an amount equal to the notional Case I assessment, including franked investment income, the upshot will be that expenses will be set against unfranked income (including annuity profits and chargeable gains) up to the point where the restriction operates, and beyond that point against franked investment income. In other words part of the relief will be in respect of franked investment income in spite of the fact that there is still some unfranked income left in charge to tax. This is in sharp contrast to the general provisions of the Act, which in relation to an ordinary trading company require that charges on income, trading losses, etc., shall be set against unfranked income in preference to franked; it is only when all unfranked income is exhausted that recourse can be had to franked investment income (Section 62(3)(b)).

15c. The effect of Section 69(2)(a), to which reference has been made in the previous paragraph, is that where the notional Case I assessment exceeds unfranked income left in charge to tax the excess is deducted from

franked investment income in determining what income is available for relief. In this way the Revenue are assured of receiving tax, either corporation tax or income tax, on an amount equal to the notional Case I assessment. If the notional Case I assessment were to be computed without including franked investment income the figure could never exceed unfranked income left in charge to tax unless there were an actual Case I liability; in which case the question of relief for expenses of management would not arise. Thus, Section 69(2)(a) becomes meaningless unless franked investment income is included in the notional Case I assessment.

15d. If it is agreed that the Revenue should be entitled to tax on the notional Case I assessment, it may seem at first glance a matter of small consequence whether the income left in charge is franked or unfranked. Indeed, with the standard rate of income tax slightly higher than the rate of corporation tax, relief of franked income might seem preferable to relief of unfranked income. However, this ignores the relationship between franked investment income and the Schedule F liability. As will be seen in § 18j, in some circumstances the rigorous application of Section 69(2) could impose a severe and unwarranted burden on a proprietary life office.

15e. The wording of Section 69(3)(a) covering the inclusion of franked investment income in a Case I computation appears to be permissive, so far as the Revenue are concerned, rather than mandatory. It should be possible, therefore, to devise a concessionary administrative procedure whereby all unfranked income is relieved of tax before franked investment income is brought into account. In applying such a procedure the Revenue would be abandoning the protection afforded to them under Section 69(2)(a) by a rigorous application of Section 69(2) as a whole; and it would be necessary, therefore, for an office to agree, as a quid pro quo, that the income left in charge to tax should never fall below the notional Case I assessment.

15f. To summarize, it would seem that a strict interpretation of Section 69(2) is not only unfair to offices in some circumstances, but inconsistent with the general principles of the new tax law. A fair procedure could be devised within the framework of the existing law, but the ideal solution would be to introduce remedial legislation.

Double taxation relief

16a. Double taxation relief is available to a life office in the same way as to any other trading company. Income from any overseas investments held as part of the Foreign Life Fund will automatically be relieved of U.K. tax, so that double taxation relief will only arise in relation to overseas investments of the home funds, and then only to the extent that the income is not otherwise relieved. When the various double taxation agreements have been re-negotiated, foreign underlying taxes will not rank as a credit against U.K. taxes on income from portfolio investments, but

foreign withholding taxes may be offset against the company's liability to corporation tax on the same income.

16b. Credit for both underlying and withholding taxes will be available against U.K. tax on income from trade investments. Furthermore, to the extent that such income accrues to shareholders 'overspill' relief will be available over the next seven years on the lines described in § 9g.

Reduced rate relief

17a. Reduced rate relief, that is relief of tax in excess of 7*s.* 6*d.* in the £, will be available as in the past in relation to taxed income used or reserved for the benefit of policyholders (Income Tax Act 1952, Section 427(2)). This relief applies both to franked and unfranked income, including chargeable gains and Case VI profits. Where the income has already attracted double taxation relief, relief equal to the difference between the corporation tax rate and 37½% will still be available to the extent that the total reliefs do not exceed U.K. tax originally payable.

In the past, the policyholders' share of taxed income has been determined by the formula $I-E-D$, where

I = investment income, less charges and Pension Annuity Fund investment income;
E = expenses of management, less annuity profits and fines, fees and profits on reversion; and
D = shareholders' notional Case I assessment.

(*Note:* Since 1956 annuity profits have been directly assessed to tax and it is, therefore, now possible for E in the above formula to be negative.)

17b. In future, I will include chargeable gains, but the formula will otherwise be unaltered apart from a possibility of some modification to D. The reasoning behind the deduction of the full notional Case I assessment is that shareholders' profits, although not taxed as such, must be regarded as covered by income which has suffered full taxation. This concept is now being called into question (see § 18h).

Proprietary offices and franked investment income

18a. An ordinary trading company is entitled to recover income tax suffered on its franked investment income by setting off that income against its own distributions to shareholders. Where franked investment income received exceeds distributions to shareholders, Section 48(1) of the Act prohibits recovery of tax on the excess but Section 48(2) allows the excess to be carried forward for relief against future distributions. In the meantime the company may secure relief under Section 62, as described in section 4 above.

18b. A proprietary life office is in the same position as an ordinary

trading company in this respect, except that Section 69(7) disallows recovery of tax on franked investment income used or reserved for policyholders. The Act gives no guidance as to how policyholders' share of franked investment income is to be determined, but by analogy with the taxation of other trading companies it might reasonably be supposed that the outgoings of the trade and reserves set aside to meet future liabilities should be met as far as possible out of unfranked income, leaving franked investment income, or so much of that income as might be needed, available to cover shareholders' profits. Even if automatic 'top-slicing' on these lines were not permissible it is difficult to see why, if a company specifically allocates a slice of franked investment income to its shareholders, this allocation should be disregarded for tax purposes. Section 69(7) refers to franked investment income 'allocated to' or 'reserved for' policyholders, which seems to imply that a company can exercise discretion in this respect and does not have to follow any set formula. If this is so shareholders' profits are automatically identified as the residue of the profits.

18c. At the time of writing the Revenue view is understood to be that, inasmuch as profit earned by a proprietary office is normally apportioned between policyholders and shareholders, each item of income contributing to that profit must be similarly apportioned between the two parties. For this purpose the basic liabilities of the business are regarded as covered, as far as possible, by untaxed income (e.g. premiums, Pension Annuity Fund investment income) leaving taxed income, and unrelieved franked investment income in particular, at the top to correspond to the total profit or a part of that profit. Each item of income which is deemed to correspond to this profit is then apportioned 'pro rata' between policyholders and shareholders, so that the franked investment income attributable to shareholders becomes

$$F \times \frac{\text{notional Case I assessment}}{\text{total profits}}$$

where F = unrelieved franked investment income subject to an adjustment to be referred to in § 18f.

18d. Prior to the Finance Act 1965 a similar problem existed in relation to profits tax and the solution adopted in this connexion was to treat the shareholders' franked investment income as being equal to the total franked investment income of the Life Assurance and Annuity Fund multiplied by the ratio of shareholders' gross profits to total gross profits. Both these methods involve an element of 'top-slicing', but the profits tax method was more favourable because it brought into account the whole of the franked investment income allocated to the annuity funds. This procedure was open to criticism and it would be even less appropriate in the post-1965 situation where income tax alone is in question. The upshot is that the suggested new formula for determining shareholders' franked investment income, which leaves out of account franked investment income

absorbed in the working of the annuity funds, is apt to be less favourable than the old.

18e. The new Revenue formula stated above ignores the arguments advanced in § 18b and furthermore, if taxed income is less than total profits as it usually is, it implies that part of the profit attributable to shareholders has escaped tax. This hardly seems consistent with the requirement that income left in charge to tax shall be at least equal to shareholders' profits, and in view of this an alternative formula has been suggested, namely

Shareholders' franked investment income

$$= \text{notional Case I assessment} \times \frac{F}{F+UF}$$

where UF = unrelieved unfranked income, including chargeable gains and Case VI profits.

The rationale of this formula is that shareholders' profit should be covered by taxed income and that the ratio of unrelieved franked investment income to unrelieved unfranked income should be the same for both shareholders and policyholders.

18f. In both the Revenue formula and the alternative formula F must not include any income of the General Annuity Fund used to measure charges, except to the extent that that income can be covered by Case VI profit plus group income. The relevant legislation is contained in the Finance Act 1966, Schedule 5, para. 9(3), which is, however, explicit only as regards that part of the franked investment income used for Schedule F purposes. The group income is added to the Case VI profit because such income is not included in the Case VI computation. The net effect is that franked investment income of the General Annuity Fund equivalent to the true profit of the fund, ignoring expenses, is made available, to the extent of the shareholders' proportion, for Schedule F purposes. Similarly, the Finance Act 1966, Schedule 5, para. 9(5) enables a company to elect not to claim relief of income tax on franked investment income of its Pension Annuity Fund up to an amount equal to the normal Case VI profit. Any income on which relief is not claimed in terms of this paragraph is omitted from the Case VI computation, the Case VI profit being correspondingly reduced. Once again the shareholders' proportion of franked investment income corresponding to the profit of the fund is made available for Schedule F purposes, but in this case there is no adjustment to compensate for the omission of group income from the computation, possibly because such an adjustment would involve a Case VI loss.

18g. The alternative formula described above is more advantageous to the office than the formula suggested by the Revenue if $F+UF$ is less than total profits and vice versa. For a purely non-profit fund $F+UF$ is likely at some stage to be considerably in excess of profits earned and in such circumstances it would be particularly hard if the office were to be denied

the normal privilege of 'top-slicing' its franked investment income to correspond with its profits. A possible solution would be to draw a distinction between the normal type of fund in which both policyholders and shareholders share in the profits and the type of fund in which policyholders receive only guaranteed benefits. In other words, the alternative formula might be applied in the first case and the Revenue formula in the second.

18h. It has been mentioned in § 17b that there is now some doubt as to whether the full notional Case I assessment should be deducted in determining the amount of income available for reduced rate relief. The wording of the Income Tax Act 1952, Section 427(2), which governs reduced rate relief, is very similar to the wording of Section 69(7) of the Act and if the Revenue formula for franked investment income were to be accepted as correct, it must follow as a consequence that in computing reduced rate relief the deduction for shareholders' taxed income would be less than the notional Case I assessment.

18j. In section 15 above the anomalies arising from a strict application of Section 69(2) of the Act have been discussed. The exact procedures to be followed have not, at the time of writing, been agreed with the Revenue but it would seem from the wording of Section 62 of the Act that shareholders' franked investment income should be determined and used to offset the company's dividend before setting either charges or management expenses against such income. This procedure is contrary to the two formulae stated above, but in any event a strict application of the new legislation could in some circumstances severely prejudice the tax position of a life office. The following figures which are based on the wording of Section 62 illustrate an extreme position:

Taxed income		Expenses	Notional Case I assessment	Outgoing dividends
Unfranked	Franked			
600	400	500	500	400

The taxed income shown above is before relief against Schedule F liability and before management expenses relief; and all profits are assumed to be allocated to shareholders. Under the pre-1965 system the whole of the expenses of 500 would attract relief because there would still be enough income left in charge to tax to cover the notional Case I. There would be a profits tax liability on 100 (i.e. notional Case I minus franked investment income), and the company would be entitled to retain the tax deducted from its own dividends. Under the new system, the franked investment income would be used to cover the dividends, leaving only the unfranked income of 600. In terms of Section 69(2) the company would be obliged to pay corporation tax on the full notional Case I of 500, so that only 100 of income would be left to set against expenses of 500. In

other words, apart from the small profits tax liability and ignoring the difference between the rate of corporation tax and the standard rate of income tax, the company would be worse off to the extent of corporation tax on 400.

18k. This grossly unfair result stems from the fact that the notional Case I has been inflated by the inclusion of franked investment income. If this income were excluded, the notional Case I would be 100 only and this figure, it is suggested, is the appropriate amount by which unfranked income should be restricted for purposes of expenses relief. The whole of the expenses would then rank for relief, as in the pre-1965 situation.

18m. The calculation of the notional Case I assessment under the old system has been described by C. E. Puckridge (*J.I.A.* **84,** 168). At the time of writing no method appropriate to the new system has been agreed. Net dividends paid to shareholders must clearly be grossed up by income tax, but to what extent should there be a further grossing up by corporation tax? The answer would appear to depend on the amount of franked investment income available to cover the dividends, any gross dividends not so covered being grossed up by corporation tax to the extent that the dividends stem from taxed income. Other components of shareholders' profit (transfers to shareholders' reserves, etc.) should apparently either be grossed up by income tax, if derived from franked investment income, or by corporation tax if derived from unfranked income, or not at all if derived from untaxed income. Further complications would arise if there were a restriction on the management expenses claim by reference to the notional Case I assessment.

18n. There has been considerable speculation as to the likely effect of the new tax system on distributions to shareholders of life offices. Until the questions raised in this section have been conclusively answered no firm opinion can be given. All that can be said is that an office which is able to cover only a small part of its distributions with franked investment income will suffer severely under the new system; while any office which is able to cover a substantial part of its dividends in this way may be relatively unaffected.

The Schedule F liability

19a. It has been explained that a company is now liable to account for income tax on its own distributions under the new Schedule F. But does this liability represent a tax on the company itself or is it merely a device for collection of a tax imposed on the shareholders? The natural assumption is that the tax is in the nature of a withholding tax and indeed the concept of the tax as a company tax does not accord with the general philosophy of the new system. Moreover, replies given by Government spokesmen in Parliament clearly indicate that the official view is that the tax is a tax on shareholders. However, legal opinion on the point is not unanimous.

19b. For most trading companies the question is of academic interest only, but it can be a vital question for a proprietary life office whose constitution lays down the basis of the division of net surplus between policyholders and shareholders. Is the net surplus now determined before or after the Schedule F liability? If it is determined after taking into account the Schedule F liability policyholders will in effect bear the major burden of the tax in many instances. If, on the other hand, net surplus is determined before the Schedule F liability, the burden of the tax will rest on the shareholders, as would appear to be the Government's intention.

Transitional problems

(i) *Pre-*1966 *profits of proprietary offices*

20a. Where a company distributes, after 5 April 1966, profits earned before that date which have suffered income tax and profits tax special reliefs of the company's Schedule F liability are available in certain circumstances as described in section 9 above. Of these reliefs the one year surplus relief will be of value to life offices, who will generally have a substantial amount of investment income in 1965/66 liable to income tax and profits tax. The alternative three year surplus relief, on the other hand, is unlikely to be of value because shareholders' profits earned over the next few years will probably exceed distributions to shareholders over the same period.

20b. Life offices are in a different position from other trading concerns inasmuch as profits available for distribution can only be determined after an actuarial valuation and there is thus a systematic and inevitable time-lag of up to five years between the earning and the distribution of shareholders' profits. It can be argued that special treatment should be accorded to life offices on this account in the form of a special notional surplus of franked investment income designed to compensate for the time-lag. The other view, to which the Government has steadfastly adhered, is that there are insufficient grounds for distinguishing between life offices and other trading companies with undistributed profits at 6 April 1966.

(ii) *The first quarter of* 1966

20c. Most life offices have in the past had non-statutory arrangements with the Revenue whereby income received in a calendar year should be regarded as a measure of the income of the fiscal year running from 6 April to 5 April. Similar arrangements have applied to expenses of management. These arrangements will not carry over into the new system, with the result that certain income received gross will escape tax, while other income from which tax has been deducted at source will not qualify for reliefs. Similarly, expenses of the period 1 January to 5 April 1966 inclusive are strictly not eligible for relief.

20d. It is understood that in practice two relaxations will be allowed.

Firstly, relief of Pension Annuity Fund investment income will be granted continuously. Secondly, expenses of the period 1 January to 5 April 1966, to the extent that they exceed expenses of the corresponding period of 1960, will be added to expenses actually incurred in 1965 in measuring expenses of the fiscal year 1965/66. The aim of this second concession is to put the office in a similar tax position to that which would obtain if the last six years' computations were to be re-opened and the true expenses of each fiscal year substituted for those of the calendar year.

Capital redemption business

(i) *Pre-*1938 *business*

21a. There is no special legislation affecting this business and accordingly a normal Case I computation of profits is made omitting investment income which has already suffered tax but including capital profits. There are therefore no chargeable gains.

21b. The Case I assessment, allowing as it does for reserves required both at the beginning and the end of the period, is normally negative and the resulting loss may be set off against both unfranked and franked income. Effectively, therefore, the business operates on a gross basis, as in the past.

(ii) *Post-*1937 *business*

21c. This business is distinguished from pre-1938 business by virtue of the fact that Section 69(9) of the Act and the Income Tax Act 1952, Section 431(2), lay down that, in ascertaining whether a company has made a loss for tax purposes, profits derived from investments must be included. In other words, as in a life fund, the normal Case I loss is ineffective and the business operates on a net basis, but without the benefit of reduced rate relief. Like a life fund the business is subject to tax on its chargeable gains. Expenses of management, limited by reference to a notional Case I assessment, are set against investment income and chargeable gains.

21d. Prior to 1965, investment income (less expenses) relating to this business was subject to income tax and in addition the gross profits, including such tax, were subject to profits tax. The new system avoids this excessive burden of tax on tax. On the other hand chargeable gains are now subject to corporation tax, whereas in the past any capital profits suffered merely profits tax.

21e. Annuities-certain will continue to be dealt with on a gross basis inasmuch as the interest content of each annuity payment still ranks as a charge on income.

Permanent sickness business

22a. This business, like pre-1938 capital redemption business, is not governed by any special legislation. A proprietary company transacting such business is accordingly able to set any Case I loss against its invest-

ment income or against profits derived from other sources. The business thus operates on a gross basis and there are no chargeable gains, capital profits or losses being included in the Case I computation. Bonuses, if any, to policyholders have to be met out of profits which have suffered tax.

22b. A mutual office transacting permanent sickness business has no Case I computation and accordingly no means of avoiding tax on its investment income. It will also in future pay tax on its chargeable gains. As against that, any profit it may earn over and above its investment income and chargeable gains will escape taxation.

Equity-linked policies

23a. In recent years many schemes have been started, mainly by the unit trust movement, providing in one package a programme of periodical investment in units of a unit trust and decreasing temporary life cover. The whole arrangement is covered by a life assurance policy, so that the investor receives his benefits in the form of a normal tax-free assurance payment, the assurance company bearing tax not only on the investment income but also, under the new system, on chargeable gains realized by the sale of its investments. The policyholder's benefit is rigidly defined in terms of the relevant units and accordingly the assurance company would normally have to meet the new tax on chargeable gains out of its own resources, unless the policy contained provisions enabling the company to reimburse itself by modifying the benefit payable to the policyholder.

23b. Most schemes of the type described have been underwritten by life companies specifically formed for the purpose and the life risk has been reassured with an orthodox life office leaving the original office apparently with no risk so long as the loadings in the premium retained were sufficient to cover expenses. Such an office would clearly have no substantial margins of profit available to it out of which it could meet unforeseen contingencies and accordingly the new tax on chargeable gains seriously threatened a number of the companies. The situation was met by including in the Act Section 69(8), which enables a company in respect of its existing equity-linked policies to pass on the tax in effect by modifying the benefit payable. Probably most offices transacting this class of business will avail themselves of this privilege, though the actual deduction from the gross benefit due to the policyholder will usually be less than the full amount of the tax, because the office will not normally be obliged to realize investments to meet claims and it will be able to make some allowance to the policyholder for the fact that its own tax liability is deferred.

23c. In theory, a similar dispensation should be allowed to orthodox life offices in respect of their non-participating business, since the entire burden of the new tax in relation to existing business will be borne by participating policyholders and, to a lesser extent, by shareholders. Existing non-participating policyholders will not suffer at all. However, the burden will not be a heavy one for very many years and with profits from life assurance

as buoyant as they are at present nobody would seek to place a penalty on orthodox non-participating contracts.

Overseas offices

24a. Overseas life offices operating in the U.K. are subject to tax on investment income relating to life assurance and annuity business in the U.K. and also on the corresponding chargeable gains of life assurance business. Annuity profits arising in the U.K. are also taxable but relief for U.K. management expenses and for charges on income is available against all income which has suffered corporation tax. Pension Annuity Fund relief and reduced rate relief are also available.

24b. Where Section 69(3)(c)(ii) of the Act and the Income Tax Act 1952, Section 430 apply, all the relevant investment income, including distributions by U.K. companies, will suffer corporation tax and income tax deducted at source will be recoverable. Such income is therefore available for relief in the manner described. Where, however, the tax position of the company is governed by a double taxation agreement overriding the general law, distributions from U.K. companies are not liable to corporation tax and accordingly remain in charge to income tax. Furthermore, Section 62 of the Act, which allows management expenses, etc., which cannot be covered by income subject to corporation tax to be set against franked investment income, is prima facie inapplicable because the income in question does not fall within the definition of franked investment income in Section 48(1) of the Act. This restriction of relief seems to be an unfair discrimination against overseas companies. However, if the double taxation agreement contains a non-discrimination clause providing that a non-resident shall not be subjected to more burdensome taxes than a resident carrying on the same activities, it is understood that relief for management expenses, etc., will be available against such part of the dividend income as relates to the U.K. business of the life office.

INVESTMENTS

25a. For many investors, including life offices, individual investment decisions as well as investment policy generally will be affected by the new tax system. Annuity business, it is true, continues on substantially the same tax basis as before, with the substitution of corporation tax for income tax on unfranked investment income and profits: but the life assurance section of the business now has to reckon for the first time with taxation of its chargeable gains. Furthermore, a proprietary office may now be more concerned than it was in the past to increase the amount of its franked investment income, though whether it will be possible to buy such income on attractive terms in the future is another matter.

25b. Taxation of chargeable gains can affect a decision to sell an investment in a number of ways. Firstly, there is the negative consideration

that arises when original cost was in excess of the 6 April 1965 value of a holding. If such an investment is sold the loss suffered in relation to original cost does not rank for relief except to the extent that the proceeds of sale fall short of the April 1965 valuation. On the other hand, if the investment is held future appreciation in value up to the original cost is received tax free. This is a common position today in relation to fixed interest securities and it tends to induce an investor to retain such securities, especially if they are ultimately redeemable at a figure higher than their current value. Certain British Government securities with a neutral zone common to all investors, as specified in Schedule 9 of the Act, may be an exception to this rule, especially if the current price is in the common neutral zone, because the purchaser's tax position in relation to future appreciation is then the same as the seller's and a reasonable price, from the point of view of both parties, should be available.

25c. Where the April 1965 value of an investment is in excess of original cost there is, at least in theory, some argument for selling because so long as the present holding is retained any fall in value within the neutral zone will not attract relief of tax. In practice an investor will be unwilling to face up to the expenses of sale and reinvestment involved in such a course unless he has doubts about the soundness of his existing investment. In these circumstances the tax situation becomes a marginal consideration.

25d. Different considerations arise in relation to price movements outside the neutral zone. Where a sale would involve a tax liability the investor is discouraged from selling because he can defer his liability by holding on. Conversely, if an investor can realize an allowable loss by selling he will be tempted to do so if he has chargeable gains against which the loss can be set. This may well lead to wider fluctuations in prices generally than have occurred in the past.

25e. Prior to 1965 investors fell into a number of categories. Some investors, such as pension funds and charities, received both investment income and capital gains free of tax, while others were taxed on both. A third group, including individuals, were taxed on investment income but not on capital gains apart from short-term gains, while finally life assurance funds were taxed on investment income but not on capital gains of any sort. In the new situation the first group will remain immune from all tax but the others will, by one means or another, suffer tax both on investment income and capital gains. This may lead to greater consistency in some sections of the market even though for individuals the rate of tax applicable to long-term capital gains is less than that applicable to investment income. For life funds the special attraction attaching to discount stocks, other than British Government securities in a neutral zone, has now disappeared.

25f. Life offices which have pursued an active investment policy in the past, particularly in relation to gilt-edged switches, will be discouraged from doing so in the future. Not only is there the possibility of losing the benefit of a neutral zone, but the calculations and administrative work

generally will be more complex than in the past and furthermore any gains realized will be taxable.

25g. Earlier in this paper the value of franked investment income to some offices has been demonstrated. The paying company on the other hand would prefer that its outgoings should be in the form of debenture interest rather than dividends, because the former is deductible in assessing profits subject to corporation tax. There may be a tendency in future, therefore, for the volume of ordinary shares on the market not to keep pace with the growth in the economy; while the search for franked investment income on the part of some companies will tend, apart from the scarcity factor, to drive up the price. Most life offices have only a limited interest in franked investment income as such in the sense that the bulk of their earnings are normally used for the benefit of policyholders and for this purpose unfranked and franked income are of equal value. Moreover, life offices are primarily interested in covering liabilities expressed in monetary terms so that the popular assumption that ordinary shares are a hedge against inflation is of only limited interest to them as opposed to individual investors. In these circumstances it is uncertain to what extent ordinary shares will in future be regarded as attractive purchases for life offices. However, any substantial reduction in the proportion of funds invested in ordinary shares is unlikely for some time, if only because the current prosperity of life offices has been largely built on investment in such shares.

TAXATION AND THE POLICYHOLDER

26a. It has been shown that life offices suffer tax both on investment income and chargeable gains, but with relief for expenses of management, limited if necessary by reference to the notional Case I assessment. It follows that whatever passes to shareholders may be regarded as having suffered tax and that the benefits payable to life assurance policyholders as a whole represent, subject to a qualification in respect of capital gains earned prior to 1965, merely a return of their own premiums together with an increment which has been fully taxed in the hands of the company. In so far as the increment consists of investment income it will have borne tax, either income tax or corporation tax, at a maximum rate of 7*s.* 6*d.* in the £; in so far as it consists of chargeable gains it will have borne tax, in present circumstances, of 30%. Should there then be a further liability to taxation on the policyholder himself?

26b. The first point to be made is that if each policyholder, instead of effecting a contract with a life office, were to make investments in his own name the tax he would suffer would on average probably be less than the tax suffered by a life fund. But an individual investing directly cannot at the same time enjoy the mutual protection and redistribution of benefits involved in a life assurance venture. This latter objective can be achieved only through the medium of a life assurance policy and this involves trans-

ferring the relevant funds and the burden of taxation to a life office. Against this background, it is submitted, it would be unfair if the policyholder were made to pay a price for this facility in the form of an additional tax liability on the monies he ultimately receives.

26c. The philosophy outlined in the last paragraph may be described as 'looking through'; that is to say, in deciding on the appropriate basis of taxation of the life company and its policyholders, one looks through to the policyholders, who indirectly suffer the bulk of that taxation, to ensure that the total burden is appropriate. In Parliamentary debates this philosophy has been specifically rejected by the Government no doubt because the new system divorces the taxation of companies from that of its shareholders. However, a life office has a contractual relationship with its policyholders as opposed to its shareholders, and any income accruing to the office and passed on to its policyholders cannot therefore be regarded as a profit to the company. The only basis on which such income can reasonably be taxed is as the income of policyholders received by the company in a fiduciary capacity. This is in fact implicitly recognized both in the old and the new legislation in two ways. Firstly, a life company is precluded from making use of its Case I loss (see § 10f), a provision which would be completely unjustified if, in fact, all investment income and capital gains were true profits of the company; secondly, all taxed income used for the benefit of policyholders enjoys a reduced rate of tax which would be inappropriate for company profits.

26d. Even in the context of the new tax system, therefore, there is no justification in principle for taxing any part of the benefits derived from a life assurance contract. Indeed, if there were to be any substantial additional taxation, savings through life assurance business would be severely depleted because other forms of investment would become relatively more attractive.

26e. Following the 1965 Act the proceeds of capital redemption policies, to the extent that they exceeded premiums, were to have been subjected to tax as chargeable gains in the hands of policyholders (Schedule 7, para. 10(1)). Under these conditions no new business would have been written and probably the bulk of the existing business would have been discontinued. Fortunately the Finance Act 1966 Schedule 10, para. 11, removes capital redemption policies entirely from the chargeable gain area. But an anomaly still persists in the life assurance field, inasmuch as some few policies do not qualify for the exemption from the tax on chargeable gains conferred by Section 28 of the Finance Act 1965. This section is apparently concerned to deny exemption to those who purchase life policies already in existence as a form of investment. However, exemption would also be denied in other circumstances. For example, an employee on leaving service might arrange with his employer to purchase from him a policy which the latter had effected in order to provide retirement benefits. In such a case the employee would find himself saddled eventually with a

capital gains tax liability, in spite of the fact that if at some stage he had taken out a new policy in substitution for the original one all subsequent liability would have been avoided. Doubts also exist in the area of trust policies and gifted policies, though the Revenue are understood to take a liberal view here, so that in practice a liability will arise only in the most exceptional circumstances.

26f. If the 'looking through' philosophy is accepted, it would seem that investment income received by a life office and applied for the benefit of policyholders should suffer income tax rather than corporation tax. In present circumstances the rate suffered, namely 7*s.* 6*d.* in the £, would be the same but if there were in future a substantial fall in the standard rate of income tax policyholders should reap the benefit instead of being tied to a tax related to company profits. The problem would be automatically solved if the suggestion put forward in § 3h that all investment income should suffer income tax rather than corporation tax were to be adopted.

26g. Finally, it should be noted that there is one tax advantage which life policyholders will enjoy in future and which they would not be able to secure by investing individually. A life office, particularly a rapidly expanding office, will rarely feel obliged to sell its investments in spite of the fact that it will be paying out benefits continuously to its policyholders. What happens in effect is that this outgo is met out of current premiums and investment income so that the investments held by the company may be regarded as continuously shifting from one body of policyholders to another. In this way the realization of investments and the consequent tax liability on chargeable gains may be deferred, to the advantage of the company and its policyholders. A company will, however, hardly be able to take credit for any appreciation in the value of its assets, whether for the purpose of distributing profits to its policyholders or of assessing its own financial position, unless it takes account at the same time of any tax that will be payable on realization of the relevant assets.

CONCLUSION

27a. In this paper a number of criticisms have been made, both of the general structure of the new tax system and of its application to life assurance and annuity business. The most important of these criticisms is that the taxation of a life office is laid down in terms appropriate to the taxation of company profits, even though the bulk of that taxation is borne indirectly by policyholders, for whom the individual basis of taxation is more appropriate. In particular the concept of 'looking through' the company to the policyholder has been specifically rejected in spite of the fact that unless this approach is adopted the relationship between life assurance and other forms of investment will be quite fortuitous.

27b. So far as mutual life offices are concerned the new tax system will, in terms of hard cash, leave their immediate position virtually unchanged,

though as time goes on the new tax on chargeable gains is bound to have some effect. However, the effect will be gradual and offices may well feel grateful that in spite of the fundamental changes that have been introduced, reasonable continuity, which is of paramount importance to long-term business, has been preserved.

27c. Proprietary life offices are in a less happy position to the extent that there are still, at the time of writing, some unresolved questions affecting shareholders. The outcome of these problems cannot be predicted, but if there is no change in the official attitude, life office shareholders generally are likely to find that their position has been prejudiced by the new law.

27d. Finally, I would like to thank all those who helped me on individual points and also J. H. Webb for his valuable assistance throughout the preparation of the paper.

ABSTRACT OF THE DISCUSSION

The author, in introducing the paper, said that since it had been written, the Inland Revenue had clarified their own attitude to most of the outstanding problems affecting the taxation of proprietary life offices as set out in §§ 15 and 18 of the paper.

First, in determining the shareholders' notional Case I assessment, that part of the shareholders' profit which was attributable to franked investment income was to be grossed up for income tax, but not corporation tax. The remainder of the profit, irrespective of source, was apparently to be grossed up for corporation tax. That was at variance with the method which he had suggested in § 18m of the paper, but in as much as the Revenue's method would in most cases lead to a larger notional Case I assessment than the § 18m method, offices were unlikely to complain, because the larger the notional Case I, the larger would be the shareholders' share of franked investment income.

Secondly, shareholders' franked investment income was to be determined by the formula set out in § 18c, but the item *F* was not to be the unrelieved franked investment income, but the total franked investment income of the life assurance fund, plus such part of the franked investment income of the annuity fund as was available in terms of Schedule 5, para. 9 of the Finance Act 1966. In other words, management expenses and charges were not to be deducted from franked investment income before making the apportionment between shareholders and policyholders. The denominator in the formula, which he described as total profits, would include all taxes suffered, as well as the cost of bonuses allotted to policyholders and annuitants, but would exclude capital profits specifically reserved for policyholders and annuitants, and not brought into the Revenue account. The suggested formula did not appear to be appropriate for annuity funds in which the annuitants shared in the profits; that problem was still being considered.

For the purposes of management expenses relief, a special reduced notional Case I was to be calculated, excluding the element of franked investment income contained in the full notional Case I. The reduced notional Case I would then represent the amount of unfranked income which had to be left in charge to tax. In that way the unfairness involved in the strict application of Section 69(2) as illustrated in § 18j of the paper would be avoided. Any management expenses which could not be relieved against unfranked income, including Case VI profits and chargeable gains, might be set against policyholders' franked investment income, but not shareholders' franked investment income under Section 62. At first sight, that appeared to conflict with Section 69(7) which prohibited recovery of income tax suffered on policyholders' franked investment income. Presumably the explanation was that any income used to cover expenses ceased to be regarded as policyholders' income. When at a later stage in the computation reduced rate relief was allowed, it would apparently be necessary to check back to ensure that the total tax charged on the office was not less than tax at the full rate on the notional Case I assessment.

The procedure for relief of management expenses which he had just outlined was on similar lines to the suggestion put forward in § 15e of the paper. It did not go quite as far as that suggestion, because of the Revenue's insistence on the concept of pro rata apportionment of items of income contributing to profit.

There still remained the problem of reconciling the proposed procedure with the exact terms of Section 69(2). In the light of the Revenue's decision, that was now of academic interest only. It should, however, be noted that the argument advanced in §§ 15b and 15c

of the paper was stated in a form which assumed top-slicing for the benefit of shareholders. If the pro rata concept was assumed, the argument was still valid, but it needed to be slightly restated. While that clarification of the Revenue attitude was to be welcomed, it was regrettable that they were still adhering to the pro rata concept, which not only led to anomalies and uncertainties, but was also based on a dubious philosophy.

Finally, two small points: first, in § 17a, when dealing with reduced rate relief, it should be mentioned that the I and E in the formula excluded the foreign component.

Secondly, § 18n, which summarized the effect of the new legislation on the shareholders of proprietary offices, should not be read out of context. In particular, it should be realized that the franked investment income available for Schedule F purposes was only a proportion of the total franked investment income of the office, and that the proportion available would vary from one office to another, and could not be ascertained from published accounts. Furthermore, while franked investment income was undoubtedly the major factor to be considered in that connexion, there were other factors such as the method of dealing with profits tax under the old system.

Mr F. B. Corby, in opening the discussion, said that it was some 18 months since the 1965 Finance Bill had been published, making fundamental changes in the approach to company taxation. There were still points to be decided in regard to a proprietary life office. Some had been dealt with since the paper was written, and the author had covered them in his opening remarks. That the new measures were complicated was quite clear, despite the second object stated by the author in his introduction. If reasonable continuity was to be maintained, that was probably inevitable particularly at a time when rates of taxation were far higher than those ruling when the structure of U.K. taxation had been built. For long-term business the importance of continuity did not need stressing, but if it was to be a partial aim, then surely the advantages of secrecy had to be weighed against the benefits to be gained from fuller and earlier consultation.

The author, in considering companies generally, had rightly pointed out how the previous philosophical basis had been eroded. To replace it with another philosophical basis which could be applied consistently and which would give continuity was, however, impossible; there were too many constraints. Philosophy was personal, especially in regard to tax. One man's tax philosophy would generally lead to another paying more! Thus in § 3h, the author had suggested that all investment income of companies should be treated as franked, the loss to the Revenue being made up by an increase in corporation tax, but it was unlikely that everybody would approve of that, even though the increase might be small.

The third of the objects of the 1965 Act changes which were mentioned in the introduction was to encourage the retention of profits made by companies, and there would be many people who shared the author's doubts about the wisdom of that. There was previous experience to support that view. A remedy involving a relaxation of principle had been suggested in § 2d, but he wondered whether after a few years, when people had become familiar with the new system, it would be regarded as quite such an inducement to retain profits as it was in 1966.

By adopting a 'looking through' approach, it was possible to criticize the effect of the new provisions on the unfranked investment income and capital gains from a company's portfolio investment. But such an approach had apparently been rejected and in any event conflicted with the legal concept that a company was an entity distinct from its shareholders. Accordingly, it was difficult to see how the author's suggestions in regard to those capital gains could be adopted without some reversal of policy and probably a yet more complicated system.

As far as life assurance was concerned, there was no reason for adopting a different approach towards the shareholders in a proprietary office from that for the shareholders in any other concern. For policyholders the position was more confused. The broad approach seemed to have been that their tax position should be kept as far as possible unchanged. For policyholders also the 'looking through' philosophy was not accepted, and although the 1966 Finance Act reduced the rate of tax on chargeable gains to the individual rate of 30% the argument was based on a comparison with investment and unit trusts. In § 26c the author had said that the fact that taxed income apportioned to policyholders was subject to tax at a reduced rate—the use of the term reduced rate relief in that context was unfortunate—seemed to be evidence of recognition by the legislature that policyholders' income was received by the company in a fiduciary capacity and might thus be adduced as a concession to the 'looking through' principle. However, whatever might be the reasons for the retention of the limit of 7*s.* 6*d.*, when it was introduced it was not with that in mind but rather to protect the position of offices with long-term contracts. Secondly, if that was so, it was doubtful if the rate would work out at 7*s.* 6*d.* The appropriate rate of tax on that basis might be determined on lines similar to the method used for building societies and it would be expected that the rate applicable to industrial branch funds—they were taxed separately so that a separate computation of the rate could be justified—would be considerably less than that for ordinary branch funds. That would lead to some interesting comparisons of benefits. Further, any consideration of the position of a life assurance policyholder was not complete without making allowance for life assurance relief on premiums, which the author failed to do, and the benefit of deferment of the capital gains tax.

For the actuary concerned with the calculation of premiums and surrender values for assurances and pension annuity contracts, the Act did not lead to any change in approach. The same had become true for general annuity business after the 1966 Act reversed the more generous treatment given by the 1965 Act, and the complications of types A, B and C remained. *I–E* would still generally apply for assurances and, although in the assessment of *I* allowance would have to be made for the tax on chargeable gains and in the exceptional case some part of *E* might only be relieved at 30%, it would generally be appropriate to allow for tax on both at 7*s.* 6*d.*

It seemed, however, that the accumulated tax on unrealized chargeable gains would present problems. The author commented that a company could hardly take credit for any appreciation in the value of its assets without at the same time taking account of any tax that would be payable on realization. The amount of any allowance for tax would remain, until the tax was payable, in the company's funds. The maximum allowance to be made would appear to be based on the assumption that the assets were realized as at the date of valuation, but that did not seem realistic and would act against the interests of the current generation of policyholders. That assumption would not even seem appropriate to a solvency valuation, for which the minimum allowance for accrued tax on chargeable gains would have regard to the expected dates of realization of the securities concerned, if the fund were closed to new business. In a valuation for distribution of surplus, where credit was being taken for increased asset values, whether it was necessary to hold the minimum allowance might be questioned although that was likely to be decided in the light of the amount of the office's 'Estate' rather than as a matter on its own. In any event, for redeemable securities the allowance for accrued tax should not be less than that calculated on the assumption that the security was held to redemption. Similar considerations would apply in deciding on the deduction from the benefit payable to the holder of an equity-linked policy to provide for the tax on capital gains. As

the author suggested, the deduction would usually be less than the full amount of the tax.

Given the trend in share prices since April 1965, the effect of the capital gains tax was so far small, or at least the effect on tax payable and accrued was small. The administrative effect was, however, far from negligible: *The Economist* had speculated recently that the cost of collecting the capital gains tax was running at a third of its yield and that the cost of taxpayers' and accountants' time was taking up the remainder. Offices which had invested in ordinary shares for many years had had to set up an elaborate system to carry out calculations on both the chargeable gains basis and the basis appropriate to the annuity funds. Those calculations had to be made not only when a security was actually sold but also when a sale was contemplated. It was a tax which appeared to conflict with many of the principles on which a taxation system should be based, and it was questionable whether the refinements necessary to secure the degree of equity which the Government apparently intended were really justified by the end results.

The author had mentioned the effects of the capital gains tax on the investor; the discouragement to sell if a profit would emerge and vice versa. The effects of the neutral zone would gradually, over quite a long period, disappear, but the general locking-in effect would remain. Tax considerations alone would have a considerable inhibiting effect on an investor who was considering switching out of a stock which he had held over a period of considerable appreciation in market values. In regard to investments in securities within the 'dollar pool', that could work to the national disadvantage precluding a United Kingdom investor from carrying out an otherwise profitable transaction. An example could be found in the progress of the price of Eastman Kodak common stock. Taking budget day 1965 price as 100 with the dollar premium, it rose by April 1966 to 207 and at that price seemed over-valued. But a sale would have cost 32 in capital gains tax and a surrender of 10 dollar premium (although the latter was not strictly relevant there) giving a net return of 165 before allowing for expenses of sale, compared with the market price of 207. It was doubtful if many investors would be prepared to back their judgment to that extent. In fact, had the sale been made, in September 1966 the stock could have been bought back for 156.

The main difficulties caused by the new legislation had been in relation to proprietary life offices, and the author had dealt with them at some length. To some extent, what he had written had been overtaken by events. A proprietary office was taxed either on $I-E$ or shareholders' notional Case I, whichever yielded the higher figure. The Revenue were not immediately concerned with the nature of an office's responsibility to its policyholders—although that could in no way be ignored—nor were the Revenue concerned with the precise method used to determine the amount of profit to pay the shareholders. It was the amount of the allocation which was brought into the calculation. Thus, it was difficult to see how the approach of specifically allocating to shareholders a slice of franked investment income, put forward in § 18b, could prove acceptable. That line of reasoning did, however, lend support to automatic top-slicing of franked investment income which would be in line with the general thinking of the Act in regard to an ordinary trading company, for example a company underwriting general insurance business. That was broadly the effect for a company transacting non-profit life business only. But where with-profit business was written and both with-profit policyholders and shareholders shared in the profits of the fund, then top-slicing for shareholders first became more difficult to justify, quite apart from the fact that, if it were permitted, the resultant Schedule F liability would not be likely to be an amount acceptable to the legislature.

On the position of the annuity funds, the interpretation to be put on paragraphs

9(3) and 9(5) of the 5th Schedule of the 1966 Finance Act had not yet been decided. There seemed to be three possibilities: to allow for Schedule F the shareholders' proportion of the Case VI profit, assuming that the Case VI profit was less than the franked investment income of the annuity fund; to allow the shareholders' proportion of the franked investment income up to a maximum of the Case VI profit; or to allow the whole of the franked investment income up to a maximum of the Case VI profit. The wording of the Act gave no support for the first view, and although by no means clear, seemed to support the last. Further, if the first view was taken, since Case VI profit was determined after allowance for surplus allocated to with-profit annuitants, an office which wrote an appreciable amount of with-profit annuity business would appear to be unreasonably restricted in the allowance it could effectively make for Schedule F purposes in respect of the franked investment income of the annuity fund.

The *Final Report* of the Royal Commission on the Taxation of Profits and Income (Cmd. 9474) commented: 'even in a time of high taxation there is a limit beyond which the refinements of a tax system cannot be allowed to go; otherwise it would be in danger of drifting altogether out of sight of two principles that ought to guide it, that it should be simple and that it should be intelligible'. At least as far as a life office was concerned there was no doubt that the situation had become more complicated than before.

Mr G. W. Pingstone shared the doubts, which were expressed by the opener in his reference to the objects of the changes involved in the new legislation, as to whether it was really a good thing to encourage the retention of profits by companies rather than forcing them into the market place, where they would find it harder to get new money if their affairs were not properly conducted. With regard to the fourth object, he was glad that the author had inserted the word 'immediate' in reference to the country's balance of payments. That object could only be beneficial from the immediate point of view, because he was well aware of recent commercial ventures abroad which had, within a few years, brought returns of the order of 30% or 50% on capital laid out, and clearly that was to the country's advantage.

In his reference in § 2c of the paper to the effect of the new legislation on dividends, the author seemed to have taken a new approach which was different from that used by others, for example in the financial press. The student, who in general would be eternally grateful to the author for having pointed the way to an understanding of the very involved legislation, might have found it easier to understand those particular remarks if the author had adopted the same approach as had become widely used elsewhere.

He agreed with the remarks in § 8c as to whether it was really worth applying capital gains tax to gilt edged. It seemed to be just not worth the cost and effort involved.

Under the heading 'The New Legislation Generally' the author ought to have made some fairly pointed references to the vast amount of work which the introduction of the new arrangements had caused. There could be no doubt that business and industry generally had been saddled with another substantial hidden charge. It was their duty as a profession to bring that to the notice of the public as forcefully as possible.

He thanked the author on behalf of students for putting in § 10f an explanation of what a notional Case I computation was. That would be extremely helpful to those who came to the subject relatively uninitiated and had difficulty in getting a proper understanding.

The author had come back to the question of previous profits for policyholders under Transitional Problems in § 20b. It was there stated: 'profits available for distribution can only be determined after an actuarial valuation'. The first point to be made in amplifica-

tion of that statement was that it was a distribution to both policyholders and shareholders. It was not one priority, but two. Secondly, it should be made clear that the making of valuations for distribution at intervals of more than one year was not something which had been done to 'cook the books' in relation to particular legislation; it was a long-established practice that many life assurance companies determined their profits only after valuations at intervals of between two and five years. He therefore regretted deeply that they had been completely unable to shift the Government's view that there really was not any difference between life offices and ordinary commercial concerns in the light of such a background. He believed that there was every difference.

In the reference to capital redemption policies in § 26e, there was pointed out the most unfortunate position which was rectified by the Finance Act, 1966. The author had not, however, indicated why it would have been unfortunate if the business had fallen by the wayside, except from the point of view of profits by life offices. The point should have been made that those policies provided a valuable source of finance for smaller businesses. That was their real justification, rather than the question of how profitable they might or might not be to the offices.

In the matter of withheld capital gains tax—which the author seemed to think was an advantage to policyholders—the point was overstated. They could still enjoy some of the advantage as individuals. It was a matter of degree rather than absolute benefit.

The author had done well to bring out the point of what the companies should do in the matter of tax provision if they were thinking of distributing capital profits to policyholders.

In the final remarks in the paper it was said: 'Proprietary life offices are in a less happy position to the extent that there are still some unresolved questions affecting shareholders.' The most important point was that, despite strenuous efforts, they had so far been unable to secure recognition of the unique circumstances surrounding the determination and distribution of their profits.

Mr R. J. W. Crabbe said that the author had pointed out that a purpose of the new tax legislation was to improve the philosophical background and so produce a more logical and simpler tax system. The attempt to do that by separating a company from its shareholders was not only artificial, but had failed either to simplify the system or to make it more logical; there was the lawyers' difficulty in deciding whether Schedule F tax was a withholding tax or not. There were also the appalling complexities which over the previous two years had absorbed the time of so many of those who should have been free to apply their energies to solving national production problems. He suggested that the most urgent problem was to modify the system so as to simplify the legislation, reduce the volume of book-work involved, and to remedy any obvious injustices.

He supported the author and subsequent speakers who had suggested that the treatment of investment income should be altered. The existing system, the double system of franked and unfranked income with different treatments, had necessitated a machinery of special exceptions which had added seriously to the complexity of the Acts. Without those special exceptions, irreparable damage would have been done to the institutions of corporate thrift which were such a vital part of the national machinery for raising capital from the small saver—and the situation was still by no means satisfactory. For example, the Chancellor had been forced to regard the freeing of the proceeds of life policies from capital gains tax as a special exception justified only 'as a measure of social policy'. A proper system of taxation should have made it clear from the outset that such a charge is double taxation.

A most undesirable consequence of the system as it stood was the additional layer of

taxation which fixed-interest investments had to bear if they were held by a corporation. That in effect stigmatized as second class securities both gilts and such socially desirable investments as house purchase mortgages.

All that could have been avoided either by the proposals which the author made in § 3h, or by other methods aimed at the same object. He himself would have preferred to see a system whereby a more logical application of the new principles was applied to investment income of all kinds. Such income, if retained by a corporation, ought to bear corporation tax. If passed on to individuals, it should all bear in total its proper taxes, viz. Schedule F income tax and, in addition, corporation tax, if and only if, it derived from a 'distribution'. That could be achieved by providing that all investment income of a corporation should be liable to corporation tax whilst in its hands, any deducted income tax being recoverable. If passed on to shareholders, such income would be restored to the income tax category by charging Schedule F tax and refunding the corporation tax. He thought that if such a system was adopted, it would automatically correct the faults which he had indicated, and would render unnecessary much of the complicated legislation on franking. In fact, he was suggesting that the profits tax precedent ought not to be followed in a situation which magnified the faults of what was originally conceived merely as an emergency provision.

The case for exempting gilts from tax on chargeable gains seemed to be overwhelming. To his mind, the one justification for the tax—the possibility that surtax-payers might secure tax-free gains—had been removed by the 'neutral zone' concession, which enabled surtax-payers to do just that, right up to the year 2004.

The result was a tax which involved an almost incredible amount of work in order to collect a revenue which could easily, in the long run, turn out to be negative—a net loss to the Exchequer. That would be clear if it was recognized that, for future issues at par redeemable at par, the aggregate gains and losses of successive holders had to balance. A negative revenue would be produced if there was a tendency for stocks to be held by tax free funds whilst their prices were rising and vice versa. Market conditions would create just that tendency.

§ 9h dealt with profits earned prior to the operation of the new tax system. He himself did not accept the arguments that the risk of depleting the income tax yield was a justification for subjecting retained profits of corporations (which had been fully taxed in the past) to a further income tax charge. This was a particularly severe injustice, for it meant that a company which had been prudent in the past and accordingly had large retained profits had thereby involved its shareholders in a heavy future liability for Schedule F tax which the spendthrift company had avoided. It would have been perfectly simple to protect the Revenue and at the same time avoid that injustice by a 'bottom-slicing' process, meaning that distributions from pre-corporation-tax profits should be free of Schedule F tax, but that that relief should only be given after all post-corporation-tax profits had been distributed.

There was a point in § 25g which needed amplification. It appeared to him that a life office could not remain indifferent to the need of its with-profit policyholders to hedge against inflation. Life office managers might not subscribe to the idea that ordinary shares were either an automatic hedge against inflation or the only one available. It might be felt that in times of uncertainty as to the effect of political or economic factors, an extra 3% or so on the rate of interest gave a much more certain hedge and therefore they should spread their investments over the whole field available. But either way, he urged that it was their duty as investors to give their policyholders the best protection possible against inflation.

Mr H. G. Clarke said that the author in his paper and in his introductory remarks had brought everyone up to date with the progress of the discussions that had been going on between the Inland Revenue and the life assurance industry on the application of the 1965 Finance Act to life assurance business. What he wished to do was to attempt to assess the validity of the bases which appeared to be formulating at that time.

He first wished to make two things clear. He did not intend to concern himself with either annuity business or foreign business, although he recognized that to several companies those were important sectors of their business. The other point was that his remarks only referred to the determination of the taxation assessments and were not intended to carry any implication as to how the taxes, when determined, should be dealt with in a company's accounts.

The underlying basis of life assurance taxation had for many years past been $I-E$ or shareholders' notional Case I profit, whichever was the greater. Accepting that as still being appropriate under the new tax structure introduced in the 1965 Finance Act, the two matters with which he was mainly concerned were the determination of Section 427(2) relief and the determination of the franked investment income which could be set against shareholders' dividends thereby relieving the company of Schedule F tax.

Section 427(2) relief had, since its inception, been determined by the formula $I-E-D$ as set out in § 17a but, as was indicated, it had recently been called into question on the grounds that it was inconsistent with the Inland Revenue's 'shareholders' proportion of surplus' method for determining the amount of franked investment income which could be set against shareholders' dividends. In order to meet that criticism it was suggested that Section 427(2) relief should in future be calculated on a 'policyholders' proportion of surplus' basis. An attempt could be made to test the validity of such a basis in the light of the original purpose which Section 427(2) relief was designed to meet, namely, to alleviate the strain placed on the solvency of a life fund by a sudden large increase in the rate of income tax, which strain would be more serious for non-profit business than for with-profit business. It would readily be observed that the new proposal based on a policyholders' proportion would give an appreciable increase in relief to a company writing mainly with-profit business, and no increase in relief at all to one writing only non-profit business. On the basis of its appropriateness to the purpose of Section 427(2) relief, that proposal would therefore score very few marks indeed, and he suggested that it should be reconsidered.

Over the years the original objective of Section 427(2) relief might have become less relevant as there had been no abrupt upward movements in the income tax rate for many years. But the advent of corporation tax had now greatly increased its relevancy. Many people believed that corporation tax could be subject to sudden and sharp increases, in which event a life fund with a large proportion of unfranked income could be quite seriously affected in the absence of an appropriate Section 427(2) relief.

The speaker then turned to the Inland Revenue's proposed basis for determining the franked investment income which could be set against shareholders' dividends, namely a 'shareholders' proportion of surplus' basis. It was quite easy to see the line of thought behind the proposal. The new tax structure appeared to carry with it the philosophy that income derived from company profits, when finally received by an individual, should have borne both corporation tax and income tax once each, but only once. Where a proprietary life assurance company divided its distributable surplus on a fixed proportionate basis between policyholders and shareholders, it seemed reasonable, on the face of it, to assume that the company's franked investment income flowed to policyholders and shareholders respectively in the same proportions, and as it was only the shareholders

who would suffer income tax in respect of their dividends and the policyholders would not suffer income tax on their policy benefits, only the shareholders' proportion of the franked investment income should be available to set against the dividends paid.

That was a reasonable line of argument, but it should be examined very carefully. The author, in § 18b, had put forward a number of points suggesting that it was questionable. It might be questionable on two other grounds. In his opinion, the case for the Inland Revenue's argument, if he might refer to it as such, rested on the proportionate division of surplus as between policyholders and shareholders. If a company first allocated surplus to its policyholders as it thought fit and then passed to the shareholders what was left over, the argument that 100% top-slicing of franked investment income should be allowed against shareholders' dividends would be clear, as the company would be comparable with any other company. In other words, if the shareholders were taking and could be seen to be taking their share last, the Inland Revenue's proposal would not be tenable. The practice of dividing surplus between policyholders and shareholders on a proportionate basis was something which had grown up over the years, and might perhaps be regarded as a convenient method of presentation, rather than representing an actual sequence of events. There were some proprietary companies which did not necessarily divide in the same proportions each year, and that would appear to throw further doubt on the validity of the proposition.

The fundamental basis of taxing proprietary life assurance companies was $I-E$ or shareholders' profits, whichever was the greater. Furthermore, in any event, the shareholders' profit part had to bear the full taxes applicable to any other company. In other words, for that purpose the Inland Revenue paid no regard to the fact that the company was a life assurance company and treated it in the same way as any other company. Was it right, therefore, when it came to the question of determining one of the reliefs available to the shareholders' profit part, that the Inland Revenue should bring the life assurance side of the picture into it? Surely for that purpose a life assurance company should also be regarded as any ordinary company and be allowed to top-slice the whole of its franked investment income. Otherwise, it was a case of 'Heads I win, tails you lose'.

Mr J. B. H. Pegler admired the author's confidence in stating what the objects of the new legislation were. He would choose his words as carefully as he could, in view of the very welcome presence of their distinguished visitors, because he could guess at some of the difficulties which they must have faced in drafting the Act, but he had to admit that he had never been very happy with the execution of the Act. Any doubts on that score, however, paled into insignificance when they came to contemplate the objects, as detailed by the author, which seemed to him almost completely misconceived.

The first object was: 'To make the tax system more equitable by bringing into charge certain capital gains, frequently speculative gains, which had previously escaped tax altogether.' There were two points there. Was it in fact equitable to charge capital gains on the realization of a stock if all the proceeds were re-invested in a similar, or even in a dissimilar stock, whereas no tax was levied if the original stock was retained? He agreed that it might be equitable to charge tax on capital gains which were used like taxable income to increase expenditure. The right way to achieve that equity, however, was to impose a tax on consumption, not to impose one which had, and was bound to have, such a discouraging effect on effective investment policy. He need not labour the point, because every one in the hall would be aware of it, and those involved in life assurance investment policy felt very strongly indeed about it. Secondly, the reference to 'frequently speculative gains' suggested that in the author's or the Chancellor's mind speculative

gains particularly deserved to be taxed; but there was no tax on 'bingo' or 'pools' gains, which were surely highly speculative. In fact, the so-called 'speculation' in investment often performed a desirable economic function.

The second object was: 'To make the tax system more simple in some respects by separating the taxation of companies from the taxation of individuals and by levying corporation tax on a current year basis.' 'More simple'! Those words would ring with a rather hollow sound in the ears of those who had struggled and were still struggling with what seemed to be endless complexities. If it was argued that those were merely teething troubles, he would answer that before they got over the teething troubles of the 1965 Act, another Chancellor of the same or a different political colour would come along and 'simplify' the position still further. He preferred the complexities he knew and understood to the simplicities he didn't.

The separation was also fundamentally bad economics. The new system put a big premium on 'do it yourself'. It was much more profitable for a life office to invest in property directly than in the shares of a property company, assuming that it could do so with anything like equal efficiency. That advantage was not confined to property investment. Under the old system it made no difference so far as income tax was concerned whether they did it themselves or left it to the specialists. Admittedly, that simple, logical and sensible arrangement was spoilt a bit by profits tax, but that ill-starred plaything of the politicians might have withered away in time. There was currently a kind of super profits tax which was a direct encouragement to carrying on any activity within their own companies or in wholly owned subsidiaries even if the results were less efficient and therefore less socially valuable. Fortunately, most life offices were very efficient property investors, so that little damage was done in that sphere, but he was surprised that the Government should encourage life offices to extend that to other spheres and thus turn themselves into industrial holding companies.

The third object read: 'To encourage the retention of profits by companies.' The author queried that one, though he trod with extraordinary delicacy in merely saying 'it has been argued' without expressing his own view. Why was the Government so concerned to protect private-enterprise concerns from having to justify their activities in the capital market? He suspected that the true economic considerations had been overridden by the political motive of trying to reduce investment income in the hands of the investor. The proper way to do that, if it was a worthy aim, was to deal with the income, by taxation, in the hands of the investor.

The fourth object was: 'To improve the country's immediate balance of payments by rendering overseas investment less attractive.' If it was to be assumed that it would never again be desirable for the U.K. to invest abroad, perhaps that object should not be criticized as vigorously as the others, though if the assumption were to be correct it could be very unfortunate for the U.K. and the rest of the world. The free movement of capital, to wherever it could best be employed to the advantage of both the investor and the company employing the capital, should be regarded as an ideal to be departed from only under the most urgent necessity, especially for the U.K. He accepted that that urgent necessity did exist at the time of the Finance Act, but he urged strongly that a fundamental change of taxation principle was not the way to deal with a short-term situation, as he believed it to be.

Most of the funds with which actuaries were connected had long-term liabilities and were affected by taxation on investment income and gains; that included the gross funds which for the purpose he had in mind were affected by tax because it influenced the relative prices of securities of different types, and of different coupon and redemption

dates. Those funds were long-term investors, and to do their job efficiently the actuaries responsible for them had to be able to take a view on long-term yields. Any fundamental change in taxation bases, such as the introduction of capital gains tax or a change in the taxation of income from abroad, radically altered the original assessment.

For investors, taxation was rather like an old car—the owner would get used to its anomalies. The fact that the clutch was a bit fierce and the gears stiff, or even that it steered a bit to the left were not important because allowance could be made for those faults; but the anomalies of a new model caused much trouble and resentment, especially when it was more difficult to drive and its performance was inferior. Of course they ought not to ask for protection against changes in taxation which were essential to the health of the economy as a whole, but he urged that they be made only after sympathetic and careful consideration of the likely consequences to everyone, including life office investors.

Mr M. E. Ogborn said that such an audience would readily agree that the proportion

$$\frac{a\,b}{c}$$

could be regarded as either $\frac{a}{c}\times b$ or $\frac{b}{c}\times a$.

That should be borne in mind when looking at § 18c, and the proportion

$$F\times\frac{\text{notional Case I assessment}}{\text{total profits}}.$$

A simple way of looking at it was to call the total profits ($F+UF+X$), and then to consider what X might be. It would be negative if the total taxed investment income exceeded the total profits. In that case it was clear that X had to be the taxed income of policyholders. If X was positive, then the denominator comprised three items; franked investment income, unfranked investment income and X. In that case, the total taxed investment income lay between an amount equal to the notional Case I (which was, by definition, the minimum assessment) and the amount of the total profits, which included the policyholders' share. The policyholders profits were not taxed directly as such, but only to the extent that they consisted of taxed investment income. Hence X, when positive, represented policyholders' untaxed profits.

The next step was to turn the expression into:

$$\frac{F}{F+UF+X}\times\text{notional Case I assessment}.$$

Taking the first case, where X was negative, the application of the formula divided the notional Case I assessment into two parts; that attributable to the franked income, and that attributable to the unfranked income minus X. It recognized the normal procedure of setting off the unfranked income first. If X was positive, what the formula implied was that there was a division of the notional Case I assessment between the franked income and the unfranked income, and also with respect to X. It seemed to be a logical *non sequitur* to match part of the notional Case I assessment against part of the policyholders' share of profits. In that case, X should be taken as zero, so that the notional Case I assessment was divided between the franked and the unfranked income as was suggested in § 18e.

Mr C. G. Myers commented on Mr Ogborn's example. If X was positive, some of the items were not taxed, and the Revenue could therefore turn round and say that the shareholders' Case I would contain part of those items, and that that part should be taxed. What they did say was that they assumed the policyholders took over those items, and they would allot from the policyholders to the shareholders some taxed items. In the past, the untaxed items which were handed over were unfranked. The author wanted to hand over a proportionate amount of franked and unfranked when X was positive, but he wanted a different form when X was negative. The Revenue would reply, 'We will follow what we have done in the past. We are then charging corporation tax on what in the past has been charged to profits tax', which was suggested in § 3d.

If, as the author suggested, for folio investment there should be one tax instead of two, with gilts at 6%, for example, and corporation tax at 40%, what would be the consequence of a business having to earn 10% instead of 6% as at present on its real capital employed, in order to justify to its shareholders continuing to trade instead of investing in gilts?

Mr W. Lundie spoke as one whose whole background had been with mutual life assurance, so that he was able to take a somewhat detached view.

In § 3h the author had propounded a simple solution to what he considered to be the undesirable repercussions of the taxation of unfranked investment income in the hands of a corporate body. He himself found it difficult to define equity in any matter of taxation without allowing some degree of self-interest to creep in. When he looked at the solution propounded, he found it was simple, but was it equitable? He would not define equity, but if the solution was equitable, it was more equitable to some than to others. The suggestion that a remedy might be by an overall increase in the rate of corporation tax seemed to him to be rather dubious from the point of view of equity. Was it fair to 'look through'? In the case of unfranked investment income, the two opposite extremes had to be distinguished. At the one end, there was unfranked investment income arising from investment of unapplied capital by a normal trading company. At the other extreme, unfranked investment income arising in the ordinary course of business from an investment company. In the first case, the author's solution ran into difficulty, unless the concept of the corporation tax was destroyed completely, and that was a perfectly tenable proposition. But given that corporation tax would continue, it was wrong to adopt that solution in the case of an ordinary trading company holding the top part of its undistributed profits in fixed-interest investment, because if there was any point in retaining profit, the purpose of that retention was to use it productively rather than simply to lend it at a rate of interest.

At the second extreme, the pure investment company solely acting as an investment medium and investing agency, he had considerable sympathy with 'looking through', and saying that something ought to be done about it.

What was the position of the life office between those two extremes? He thought there was some ground for 'looking through' to the policyholders, but what about the shareholder? Was the shareholder in the life office investing in the top part of an investment trust or was he investing in a company which held investment as part of its ordinary trading?

The author's description of the problem of allocation of franked and unfranked income to shareholders in § 18 was illuminating, because it illustrated how difficult the legislation was, because it was indeterminate. Quite apart from equity, any tax legislation which did not define exactly what the current quantum of tax was and what it was likely to be in the future was not very good legislation.

Mr J. R. Hemsted was glad that the author had not confined himself merely to the interpretation of the Act, but had gone on to suggest some improvements or alterations in the light of the stated objectives. But even those stated objectives were not quite sufficient. Tax was becoming more and more important in the management of the economy and had displaced monetary controls as the main instrument. The objectives of the Act should be looked at in the light of the national economic objectives, which were generally accepted to be growth without inflation, with a certain amount of social justice and equity so far as tax was concerned. Before referring to equitable tax treatment, he wished to look at the second and third objectives in the light of the question of economic management. Economic management usually involved the control of production to get growth, and the control of saving to provide capital without inflation. There were those two principal controls, which might have to be operated quite independently. In the past they had tended to be linked together, and perhaps insufficient attention had been given to stimulating saving at a time when an attempt was being made to increase production.

From that point of view, there was a case for separating the company from the investor on the grounds that increased production was a decision taken by the company, whereas saving was a decision largely taken by the individual. It might be necessary to stimulate one while holding back the other. That could be done even under the old system by giving appropriate tax reliefs, but the fact that income tax applied to both in the past might have been some hindrance to good economic management. He was not against the objective of treating companies and individuals separately, nor against encouraging the retention of profits by companies. The Act had the effect of making the company net rates of return on equity capital approximate, on average, to the gross rate of return which the investor might look forward to on an equity investment in the market. That arose since companies did not normally invest in a new project of their own if they could do better by buying the shares of other companies, but it meant that personal saving was going to be greatly discouraged under the new Act. He hoped there would be some investment income relief to the private individual.

In regard to fair treatment as between taxpayers, he agreed that equity in that sense was difficult to define. If levied upon economic grounds, it could not be said that one tax was unfair compared with another and he therefore did not accept the 'looking through' principle; but it could be said that within one type of tax there should be equitable treatment. It was, for example, wrong to say that it was equitable or inequitable that income should be taxed and capital gains should not. Capital gains should be treated separately and taxed or not according to their own merits. Previous speakers had suggested that activity in the capital markets was desirable economically, and his personal opinion was that it should be encouraged, and the first thing that should be done for that purpose was to abolish the capital gains tax.

Mr G. V. Bayley, in closing the discussion, said that the subject which they had been discussing broke down conveniently—though not so simply—into 97 Sections and 22 Schedules, with, after a twelve-month, an afterthought of 53 Sections and 13 Schedules for good measure. It was more than his life was worth to attempt to carry out a full summary, even if he were competent to do so. Instead, he would speak mainly about those aspects of the paper which were intriguing to them as a profession, and particularly those which were still matters of contention.

He was thankful for §§ 1 to 9, giving a general description of the new legislation. A number of speakers had commented upon that part of the paper. Mr Pingstone and Mr Pegler had attacked the objectives of the new system, one of them inasmuch as it

encouraged company retentions which might not be efficiently invested. That was a fair criticism, but it was also a big assumption that if more profits were distributed, the excess would be wholly saved.

One or two of the new rules had considerable significance for life offices. The first concerned the treatment of franked investment income received by one company from another. That income was permitted to float at the top of the receiving company's profits, and was accordingly treated as forming the top slice of its distributions to shareholders.

The second point concerned the new—less favourable—treatment of dividends from investments overseas. It seemed unrealistic to expect more favourable treatment in principle for life assurance funds than for the private investor. The change for the worse was, however, aggravated for investment in some countries by the 25% currency surrender which, as an incentive to inefficiency, took the prize of the year. The problem was whether it was worth investing overseas under the new handicaps.

He was interested in the author's study in §§ 3f and 3g of the greater attractions of investment incomes for some investors. His suggestion that unfranked investment income should be treated as franked, or Mr Crabbe's alternative proposal, had advantages, one of which would be to meet Mr Pegler's objection to the present discouragement of specializing in property investment. Mr Lundie had pointed out that the effects were far-reaching, and it would still produce its own set of anomalies. No company could, for example, afford to own its own doorstep, or even its own machinery.

A great deal had been said about the new burden of tax on capital gains. The discussion had ranged over the problems which currently beset investment managers of life assurance and similar funds, and he would try to summarize the main points. For many existing holdings it had become intolerably complicated to discover the tax implications of a potential sale. As the opener illustrated, the buying and effective selling price of a particular stock to the fund could differ quite widely and a stockbroker or other adviser would not normally know the latter. Mr Crabbe's suggestion, and that of the author, of freeing 'gilts' entirely would certainly help.

The motives behind the transitional arrangements for introducing the long-term gains tax were no doubt admirable, but the tax-free runs which they created seemed likely to inhibit the market for some time to come. In due course, changes of investment and especially new money, would diminish the significance of tax-free runs, although the reward for a successful investment would continue to be a disincentive to sell.

Because of the nature of life assurance business, tax on gains merely reduced the benefits payable under the policies, and was therefore gathered at the expense of saving and not of consumer spending power. It would create a better understanding of the effect of all the new taxes if life assurance business was recognized more widely as a long-term savings industry.

The need to make strategic changes in portfolios periodically diminished the advantage of postponing tax, as was mentioned in § 26g. For that reason, he went most of the way with those who believed that a rate of 30% was unjustifiably high in relation to the average rate that would be paid by the aggregate of policyholders as individuals.

Undoubtedly the most teasing set of problems introduced by the new legislation had been the tax treatment of shareholders of proprietary life offices. The difficulties could be broken down into several parts all interlinked: the allocation of franked investment income between shareholders and policyholders; Section 427(2); the 1966 legislation governing annuity funds; and finally Section 69(2).

As the author had explained, no method was prescribed in the Acts for determining

what part of the franked investment income was reserved for policyholders. § 18 set out the opposing suggestions as to how the shareholders' allocation should be calculated. Considering purely life assurance funds writing only non-profit policies, where all profits were assigned to the shareholders, franked investment income was effectively top-sliced by the Revenue's formula, into shareholders' profit, for franking relief on dividends. That was wholly consistent with the treatment of non-life business and indeed with the general rules for other enterprises to which he had drawn attention earlier. When profit had to be shared between policyholders and shareholders, it was also common ground, as implied in Mr Ogborn's analysis, that the franked investment income should still be effectively top-sliced into the total profit; but should that franked investment income then be shared pro rata between policyholders and shareholders in the same manner as the profits, or could it be top-sliced into the shareholders' fraction? That was the question. The Revenue had throughout taken the view that if profit was shared, then so were its components in proportion. That arrangement seemed to visualize a joint commercial venture where the parties were essentially at one, shareholders and policyholders in double harness, purchasing investments and maximizing profits for their joint benefit. The opposing view was that the parties were essentially at arm's length, and that the basis of division of profit was what the market would stand when the company sought to market its participating contracts. Like Mr Clarke, he believed that those were the facts of life, and that the events of the past year had underlined them. On that view, there was no difference, for the purpose under discussion, in the company selling non-profit policies or with-profit policies in the ultimate endeavour to maximize their shareholders' profits.

Turning to the actual legal provisions, Section 69(7) merely excluded the repayment of income tax on franked investment income reserved for policyholders; it did not specify a pro rata allocation. The new legislation went no further than to look to the company's having franked investment income available for Schedule F relief. From all that, it followed that the same franking rule that applied to shareholders of wholly-non-participating funds, and indeed of all other commercial enterprises, ought not to be denied to the shareholders of participating funds.

If that approach were accepted, no difficulty would occur in the second stage of the problem, the interpretation of Section 427(2), because the anomaly referred to in § 18h would not then arise, nor would any of the others, such as that mentioned by Mr Clarke.

In regard to annuity funds, the Finance Act 1966, Schedule 5, para. 9, was also silent about how much franked investment income unrelieved by that paragraph could be attributed to shareholders. Once again, it had to be determined how much of it was reserved, etc., for policyholders and therefore denied to shareholders by Section 69(7). The franked investment income in question was identified with the annuity funds in general, and with the Case VI profits in particular. That might suggest that those profits should be chased through to ascertain their ultimate destination, according to the circumstances of a particular office. There were several points about that. A Case VI profit was not a commercial profit, because it left expenses out of account. The opener also pointed out that it was a net result after profits had been reserved for annuitants. For both those reasons, the formulae given in §§ 18c and 18e both seemed to be unsuited to the circumstances. However, overriding all that there stood the absolute purity of the proposition that franked investment income unrelieved was income of the company, and therefore wholly available for franking shareholders' dividends.

The author had outlined the official interpretation of Section 69(2) in his opening

remarks. He believed that the Revenue had done the best they could with an exceptionally difficult piece of legislation.

A great many other matters had been mentioned during the discussion, notably Mr Pegler's plea for only carefully considered changes of gear and direction. There was Mr Crabbe's suggestion of extending the use of pre-1965 reserves out of taxed profits, and the criticisms of the failure to 'look through' more often. All those matters deserved the most careful thought and attention.

To sum up, they were emerging from a traumatic experience. Their basic framework was relatively unscathed. Policyholders were taxed in the main as they had been before, but life assurance funds now had to grapple with the complexities of the capital gains tax. The discussion had emphasized the diversion of skilled resources to a vast amount of unproductive work.

Proprietary offices had, in general, suffered because of the interpretation which had been placed—in his view wrongly—upon their function, and upon the legislation itself. However, there were reliefs here and there which softened the blow for those with favourable patterns of business and investments. But the fundamental difficulty for them seemed to be basically unresolved.

Mr Bayley paid two tributes. The first to the author for the very high standard of his paper, not only for its comprehensive treatment, but particularly for its lucidity. They were also in his debt for the knowledge and the skill which he had brought to bear upon their deliberations over the past two years.

He also paid tribute to those who walked and worked in the corridors of tax. In spite of the pressure of work, the officials of the Inland Revenue had always listened patiently to their representations, and helped as best they could to solve some incredibly difficult problems. He was confident that those friendly relations would continue, and he hoped that the author's paper and the discussion would help them to appreciate some of the anxieties.

The President (Dr B. Benjamin), in proposing a vote of thanks to the author, said that he found it difficult to do so in full enough measure. There were few subjects more difficult than taxation, and in attempting an exposition of recent legislation and associated problems, the author had clearly taken on a very difficult task. That he had done so with great success was evident from the discussion. A number of epithets were used of the paper, some of them critical and even whimsical, but the most frequently used were 'illuminating' and 'lucid'. They were all indebted to him, and particularly the students who would gain much from reading the paper. He always liked to think that papers read to the Institute, apart from their intrinsic value to the profession, would be of educational value to the younger generations.

The author, in acknowledging the vote of thanks, referred to the major questions of principle covered by the discussion.

First, there was the question of top-slicing the franked investment income for the benefit of shareholders. It seemed right on general principles that that should be permitted, and he agreed with the argument which the closer adduced in that connexion.

Secondly, there was the 'looking through' philosophy. In the broad context, he suggested that all investment income and all capital profits from portfolio investments should be free of corporation tax but, like franked investment income, should suffer in the hands of the company the same taxes as would apply to an individual. That idea attracted some criticism during the discussion, but also some support. Mr Crabbe put forward an interesting variation, under which corporation tax would be imposed on all investment income on receipt by the company, but subsequently refunded on distribution to shareholders. He

still preferred his own suggestion, if only because it adhered more closely to the 'looking through' philosophy. A number of speakers pointed out that his suggestion did not avoid all anomalies, but that would be impossible in a system which imposed two tiers of taxation on profits accruing to an individual through a company, and only one tier on profits accruing directly. He would prefer his own set of anomalies to those which were being endured at the moment.

In the particular field of life assurance, the opener criticized the fact that in dealing with the taxation of the policyholder, he had left out of account the tax rebate on life assurance premiums. That was quite deliberate, because it seemed to him that if the legislature chose—and he thought it should—to encourage life assurance by that means, it should not detract from the benefit of the rebate by imposing unwarranted tax burdens in other directions. In the event, policyholders had to a large extent been given the benefit of the 'looking through' philosophy, though that had emerged accidentally and not as a matter of principle. He would like to see the 'looking through' principle recognized in relation to policyholders so that the actual taxes imposed on income and capital gains applied for their benefit should be not corporation tax, but the taxes appropriate to an individual.

The author also subsequently wrote:

Mr Pegler admired my confidence in listing the objects of the new legislation, but I was in fact merely echoing statements made on behalf of the Government. I agree with him that not all the objects have been fulfilled or are likely to be fulfilled. I also agree with most of his criticisms of the new tax structure, though I do not consider a tax on consumption to be an effective alternative to the taxation of capital gains.

I am grateful to Mr Crabbe for his amplification of my remarks in § 25g. Life offices have to compete with other forms of saving and they may be expected, therefore, to invest in ordinary shares whenever the price structure is such that they appear to be the best purchases in the long-term interests of policyholders.

Mr Clarke remarked that relief under the Income Tax Act 1952, Section 427(2), to which I referred in the paper as reduced rate relief, will be available in future on any taxed income attributable to the policyholders' share of profits. Relief will, however, also be available as in the past on any taxed income needed to sustain the basic liabilities of the business.

A number of speakers appeared to assume that the alternative formula set out in § 18e was my own suggestion or at least that it had my support. Neither assumption is correct, though I agree with Mr Ogborn that the requirement that the minimum tax liability shall be tax on the notional Case I assessment points to the alternative formula rather than the Revenue formula. On the other hand, the alternative formula is unsatisfactory as it stands, for the reason I mentioned in § 18g. The formula could, however, be re-stated in a modified form which would overcome its weaknesses. The first step would be to top-slice franked investment income into total profits on the lines assumed in the Revenue formula, the balance of the total profits being covered as far as possible by other taxed income. For this purpose capital profits reserved for policyholders and annuitants would be excluded both from taxed income and from total profits. This would leave, say, taxed income of F' and $(UF)'$ in the profit margin, as in the Revenue method. The next step would be to identify the notional Case I assessment wholly with taxed income, taking franked and unfranked income in rateable proportions. The modified alternative formula for shareholders' franked investment income would then become

$$\text{notional Case I assessment} \times \frac{F'}{F'+(UF)'}.$$

There are, therefore, three different methods for determining shareholders' franked investment income, all starting from the point at which total profits have been identified. The first method, which in my opinion is the correct one, is to top-slice all franked investment income into the shareholders' profit. The second is the modified alternative formula which identifies the shareholders' profit with rateable proportions of taxed income contained in the total profits. The third and least favourable formula is the Revenue formula, which assigns to shareholders a pro rata share of all profits, whether taxed or not.