REVISION COMMITTEE.

REPORT.

1. AT their Meeting on the 14th December, 1926 (Cabinet 64 (26), Conclusion 3), the Cabinet accepted the proposal of the Chancellor of the Exchequer that a Cabinet Committee to be composed as follows:—

   The Chancellor of the Exchequer (in the Chair),
   The Lord Privy Seal,
   The Secretary of State for War,
   The First Lord of the Admiralty,
   The Attorney-General,
   The Financial Secretary to the Treasury,

should be appointed to study certain documents relative to tax avoidance, to be circulated by the Chancellor of the Exchequer, and should meet at the beginning of February, 1927, to prepare a Report for consideration by the Cabinet.

The Lord Privy Seal was unable to attend the meetings of the Committee.

2. The Committee in the first instance considered the case of people who avoid British taxation by going to live in the Channel Islands (a matter brought into great prominence by the Houston case) or by forming one-man companies in those Islands. The need for action in this class of case being both clear and urgent, the Committee have settled a scheme* which is now under negotiation with the governments of the Channel Islands.

* Vide note at end of report.
3. As regards all remaining aspects of the general question, the Committee set out in Part I of the following Report a scheme of action and in Part II of the Report an explanation of the circumstances which give rise to this scheme and of the objects which the scheme is designed to secure.

4. The questions for the consideration of the Cabinet are—

(a.) Whether any action should be taken at the present time;
(b.) If so, whether the whole scheme set out in Part I of the Report should be adopted, or portions of that scheme should for the present be postponed.

PART I.—PROPOSED SCHEME OF ACTION.

1. Legal avoidance of Super-tax through the medium of private companies.

Amendment of Section 21 of the Finance Act, 1922 (which deals imperfectly with this question), in the following respects:—

(a.) The Section to be made applicable in the case of all companies registered under the Companies Acts which are under the control of not more than five persons;
(b.) Profits of such companies not to be regarded as reasonably withheld from distribution when they are applied in payment for the acquisition of the business, or when they are applied to meet any requirements of an artificial or fictitious character;
(c.) Provision to be made to prevent the Section being evaded on the liquidation of a company;
(d.) Provision to be made to prevent the Section being evaded by the institution of a chain of companies.

2. Legal avoidance of Death Duties through the medium of private companies.

(a.) Provision to be made that, on the passing on death of the shares of a person who had a controlling interest in a private company, or who was partner in or sole owner of the business which the private company took over, the shares passing may be valued by reference to the intrinsic value of the assets of the company less the value of the holdings of the other shareholders and debenture holders;
(b.) Provision to be made that if the vendor of a private company draws not less than 50 per cent. of the profits otherwise than as dividends he shall be deemed on his death to have had an interest in the assets of
the company of a value equal to the value of the same proportion of
those assets as his income from the company bore to the whole profits;

(c.) Provision to be made that where a person has had a life interest
in property that property shall be deemed to pass on his death, notwith­
standing that the property has during his lifetime been transferred to a
private company.

3. Legal avoidance of Super-tax by sale of securities cum dividend
and repurchase ex Dividend.

Provision to be made that the dividend in such cases may be treated
as income of the vendor shareholder on an accrual basis, a corresponding
relief being given on the same basis to taxpayers damnedified by the
declaration of two years' dividends within one Income Tax year.

4. Legal avoidance of Income Tax and Super-tax through voluntary
dispositions of an artificial character in favour of Charities.

Provision to be made to authorise tax to be charged as if such
artificial deeds had not been signed.

PART II.—EXPLANATION OF THE CIRCUMSTANCES GIVING RISE TO THE
SCHEME IN PART I AND OF THE OBJECTS AIMED AT.

(Note.—The marginal references are to the proposals in Part I.)

1. Legal avoidance of taxation may be defined as an artificial or
unnatural disposition by the taxpayer of his property or his income, of
such a nature that its object may be divined to be and its effect is, greatly
to reduce the burden of taxation upon him without materially altering
his power of enjoyment of the property or income so treated. Whatever
view may be taken of the ethics of such arrangements, there is no doubt
as to their legality. As Lord Sumner has recently stated in a judgment
in the House of Lords—"the highest legal authorities have always
recognised that the subject is entitled so to arrange his affairs as not to
attract taxes imposed by the Crown so far as he can legitimately do so
within the law."

2. The incentive to legal avoidance is to be found in the high rates
of taxation imposed during the war. Its practice under existing law is
extremely easy. The Attorney-General and other members of the
Committee have been able to confirm out of their own experience the
views of officials as to the spreading knowledge of the most convenient
forms of tax-avoiding arrangements and the likelihood of a great develop­
ment as time proceeds. The figure of present loss although it cannot be
precisely computed is very substantial and, unless steps are taken to deal with the major aspects of the problem, the loss will soon assume such serious proportions as to make remedial legislation imperative. Parliamentary discussions in 1926 and the publicity given to the Houston case show also that the subject is beginning to attract much public attention.

3. Any legislation which is decided upon will no doubt be liable to be defeated by legal ingenuity, but there is no reason to suppose that, provided amendments and extensions are undertaken from time to time in the future as circumstances may dictate, the present situation cannot be very materially improved and the glaring inequalities between individual taxpayers, which legal avoidance produces, cannot be reduced to a minimum.

4. On the other hand, proper weight must be given to the Parliamentary and other controversies and resentments which legislation of this character inevitably entails. Experience shows that anti-avoidance legislation is very difficult and that, apart from difficulties, it is liable during its passage through Parliament to create great apprehensions in quarters—especially business quarters—which are not in fact aimed at by the actual proposals put forward.

Legal avoidance of Super-tax through the medium of private companies.

5. Legal avoidance of Super-tax through the medium of private companies is effected by withholding the profits from distribution as income. The owner of a business or of a block of property transfers the business or the property to a company in which he is the principal shareholder. If he draws out the profits as income (in the form either of dividends or of fees), he will be liable to Super-tax just as if he had not formed the company. Instead, he draws them out in the form of loans which the company subsequently cancels, or he leaves them to accumulate in the company until he finds it convenient to liquidate the company and start another; and so on. Section 21 of the Finance Act, 1922, is designed to prevent avoidance in this manner. The clause as introduced was very radically amended during its passage through Parliament, and the Section as it emerged is extremely imperfect. The underlying conception of the Section is that in the case of certain defined companies, if the profits are unreasonably withheld from distribution as income (so that they escape Super-tax), Super-tax should be charged as if they were profits of a firm.

6. The companies to which the Section now applies are companies:

(i.) Registered (under the Companies Act) since the 5th April, 1914, and
(ii.) Of which the number of shareholders does not exceed 50, and
(iii.) Which have not issued any of their shares as the result of a
public invitation to subscribe, and
(iv.) Which are under the control of not more than five persons.

As the fourth of these provisions by itself adequately limits the field
of review, while the first three enable taxpayers to escape taxation with
extreme ease, the Committee propose that in future only the fourth
provision should remain, i.e., that the Section should apply to companies
registered under the Companies Acts which are under the control of not
more than five persons.

7. In the case of a company to which the Section applies, its
provisions may be made operative (i.e., the Super-tax may be assessed as
if the profits were profits of a firm) if the company has not distributed a
reasonable part of its income, with the proviso that in the determination
of this question regard is to be paid “not only to the current requirements
of the company’s business but also to such other requirements as may be
necessary or advisable for the maintenance and development of that
business.”

8. This proviso is extremely wide and vague and enables taxpayers
to get through the net in circumstances which were certainly not
intended. To take an extreme case, a person forms his business into
a company, and as the sole shareholder in the company he devote the
profits to redeeming the debentures which he has issued to himself in
payment for his own business: he is at present able to argue that the
expenditure is a current requirement, or at any rate that it is desirable
for the development of the business that the profits should be so applied,
and he may escape super-tax upon them.

The Committee propose—

that the requirements of the business for maintenance and development
to which regard may be paid in determining whether the
distribution of profit is reasonable should exclude sums expended
on the purchase of the business, &c., acquired by the company or
in the redemption of debentures or other capital indebtedness or
in meeting obligations of the company in respect of the acqui-
sition of such business, &c., and also sums expended in pursuance
or in consequence of any fictitious or artificial transaction.

9. In order to close up other loopholes in the section the Committee
propose—

(i) that the section should be amended in the sense that on the liqui-
dation of any company to which the section applies the income
for the period or periods up to the date of liquidation shall be
treated for the purposes of the section as if it had continued in
existence.
(ii) that the section should be amended to prevent the defeat of its object by the institution of a chain of companies.

*Legal avoidance of Death Duties through the medium of private companies.*

10. A loss of duty is regularly suffered when a business or property has been transferred to a private company. The loss may occur from one or more of four causes:

(a) gift of a proportion of the shares to relatives or intended heirs—a mere gift *inter vivos*;

(b) the comparative unmarketability of shares in a private company passing on death;

(c) in the case of agricultural land only, the non-reflection in the value of shares of what is often loosely called either the "amenity value" of the land or the special value attaching to the "pride of ownership," *i.e.*, the price which purchasers will in fact pay for agricultural land in the market in excess of a reasonable price based on income-producing capacity;

(d) artificial manipulation of profits which, through reducing past dividends, diminishes the market value of the shares at the time of the death of the shareholder.

11. The Committee propose that provision should be made to avoid this loss (*except under (a)*), not indeed on the passing on death of any shares in private companies, but on the passing on death of the shares of a person who had a controlling interest (more than 50 per cent. of the voting power) and on the passing on death of shares of a person who was previously partner in or sole owner of the trade or business which the company took over. The method recommended for avoiding the loss in these cases is to give the Revenue authorities power, if they think fit, to take the value of the shares passing as being the value of the assets of the company less the value of the holdings of the other shareholders and debenture holders.

12. Avoidance of duty takes place on a larger scale (although in far fewer instances) in cases of the following type. The founder of the company may take practically no shares himself and may give practically all to his intended heirs but as permanent governing director he votes himself most of the profit as remuneration and retains complete power to deal with the property as he pleases.

13. The Committee propose that if the founder of the company draws not less than 50 per cent. of the profits otherwise than as dividends, he shall be deemed on his death to have had an interest in the assets of the company of a value equal to the value of the same proportion of those assets as his income from the company bore to the whole income of the company.
14. Avoidance similarly takes place on a large scale where tenant for life and remainderman of settled property dispose of their interests to a private company and the tenant for life receives an equivalent for his life interest by way of annuity, dividend, or otherwise.

The Committee propose that where a person has had a life interest in property, that property shall be deemed to pass on his death notwithstanding that the property has during his lifetime been transferred to a private company.

15. Acceptance of the two last-named recommendations involves the corollaries—

(a.) That powers must be taken to obtain necessary particulars from the companies concerned;
(b.) That the duty charged on the death of the founder of the company shall be ultimately recoverable from the company he created, for the reason that the company alone has the assets in respect of which the charge arises.

Legal avoidance of tax by the sale of securities cum dividend and their repurchase ex dividend.

16. Avoidance of direct taxation by sale cum dividend and repurchase ex dividend may be illustrated by the following example:—

A large taxpayer owning £100,000 of War Loan expects to receive a dividend on the 1st December amounting to £2,500. Shortly before that date he sells his holding for £102,500 and immediately after he buys it back for £100,000, the person with whom he is dealing taking the dividend. The net result is that the £2,500 dividend ceases to be the income of the large taxpayer and becomes the income of the person with whom he dealt. If that person is a Company, no Super-tax is payable, and further, if that person is a Finance House, the Income Tax also upon the dividend of £2,500 may be lost to the Exchequer. All that the Revenue gets in exchange is tax upon any small commission that may be charged on the transaction. Transactions of this character may be purely paper transactions effected by book entries; they may be carried out in this country or abroad; they may be carried out between the taxpayer and a private Company abroad which is his own creation.

17. Although the evidence is not conclusive, there is a good deal of reason to believe that the loss to the Revenue from this procedure is very substantial. To remedy the evil, it is proposed to empower the Special Commissioners of Income Tax to assess persons who are in fact avoiding duty in this way to super-tax on the footing that the income from the investments accrued from day to day, and that on a sale or
other transfer, the transferor had received an amount of income equal to
the amount accruing up to such date. Action should be limited to
serious cases of loss, and accordingly the statutory provisions should
only apply where the effect of the transaction was to diminish the
liability by more than 5 per cent. of the total amount of tax.

18. It is also proposed to remedy at the same time the hardship of
subjecting to super-tax liability cases where dividends for two separate
years happen to be declared within a period of twelve months ending on
the 5th April. In such cases it is proposed that where an individual
proves to the Special Commissioners that (by reference to the provision
that income chargeable with Income Tax by deduction should be deemed
to be income of the year in which it was receivable) his income as
estimated for Super-tax represented more than the income attributable
to a full year on the basis of day to day accrual, the Special Com-
missioners should be authorised to give such relief as should be just.
The relief will only be given in cases where the super-tax liability is
increased by more than 5 per cent. of the tax payable by reason of more
than one year's income coming into the same super-tax return.

**Legal avoidance of Income Tax and Super-tax in respect of voluntary
contributions to charities.**

19. A person who makes a voluntary contribution to a charity is
not entitled to treat that expenditure, any more than any other form
of expenditure, as a deduction in arriving at his Income Tax and Super-
tax liability. Certain persons, however, avoid payment of these duties in
respect of their charitable subscriptions by contracting by deed with
the charities concerned to make annual subscriptions for a period
exceeding six years. As these dispositions are in form irrevocable and
operate for a period of more than six years, they elude the relevant
provisions of Section 20 of the Finance Act, 1922, which was designed to
prevent legal avoidance of Income Tax and Super-tax in respect of
voluntary allowances generally. A subscriber, having signed such a deed
in favour of a charity, deducts Income Tax from his annual contribution,
and the charity reclaims this tax from the Exchequer by virtue of the Income
Tax exemption in favour of the income of charities. If the subscriber is
a Super-tax payer, he also deducts the annual contribution (as being a
legally enforceable annuity) from his statement of total income for the
purpose of that tax. The Exchequer loses Income Tax in all cases and,
in many instances, Super-tax also. The present loss is estimated at
about £100,000 a year. The practice is rapidly spreading and, unless
checked, may in a few years cost a sum not far short of £1,000,000 a
year.
20. The element of artificiality in these transactions lies in the fact that, although in form the deeds are irrevocable for the period for which they are granted, they are in actual fact practically revocable at any moment at the will of the donor, and the payments therefore are just as much voluntary contributions as if no deed had been signed; and this for the reason that no charity would be so foolish as to spoil the market by suing under one of these deeds, and, in fact, many charities expressly state that they would not think of doing so. The matter can be remedied by an appropriate amendment of Section 20 of the Finance Act, 1922.

Signed on behalf of the Committee.
WINSTON S. CHURCHILL, Chairman.

Treasury Chambers, 14th March, 1927.

NOTE.

The arrangements now under negotiation with the governments of the Channel Islands for prevention of legal avoidance in those Islands are briefly as follows:

(a.) British subjects permanently established in the United Kingdom who remove their residence or domicile to the Channel Islands shall, for a period of 20 years, continue to be liable to British Income Tax, Super-tax and Death Duties as if they had not removed;

(b.) The governments of the Islands shall dissolve tax-avoiding companies formed in the Islands for the benefit of British taxpayers—subject to safeguards for native islanders and reliefs for hard cases as may be determined after negotiations with the Island authorities have been carried through.

The Isle of Man will be subsequently approached on the same lines.